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1995

## Comprehensive engagement manual, Volume 4: Reporting

George Marthinuss

Luis E. Cabrera

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***Comprehensive Engagement Manual***

***Comprehensive  
Engagement  
Manual***

**VOLUME 4: Reporting**

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**VOLUME 4**



**AICPA**

**VOLUME 4: Reporting**

***Comprehensive  
Engagement  
Manual***

*Authors:*  
*George Marthinuss, CPA*  
*Luis E. Cabrera, CPA*

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# **AICPA**

V O L U M E 4

# ***Comprehensive Engagement Manual***

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The manual is issued as a nonauthoritative kit of practice aids and is not intended as a substitute for professional judgment or for authoritative technical literature.

The documentation in this manual is not a substitute for development and implementation by a firm of a system of quality control that is appropriately comprehensive and suitably designed in relation to the firm's organizational structure, its policies, and the nature of its practice.

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1 2 3 4 5 6 7 8 9 0 T I 9 9 8 7 6 5



**AICPA INTEGRATED PRACTICE SYSTEM  
COMPREHENSIVE ENGAGEMENT MANUAL**

**TABLE OF CONTENTS**

**VOLUME ONE – ENGAGEMENT PERFORMANCE**

- 1 INTRODUCTION**
- 2 PRE-ENGAGEMENT CONSIDERATIONS AND AUDIT PLANNING**
- 3 THE AUDIT APPROACH: THE ABC SYSTEM OR THE ALL-SUBSTANTIVE APPROACH**
- 4 PERFORMING COMPILATION AND REVIEW ENGAGEMENTS**
- 5 EVIDENCE ACCUMULATION**
- 6 DOCUMENTATION**
- 7 COMPLETING AN AUDIT ENGAGEMENT**
- 8 SUPERVISION AND REVIEW**

**INDEX**

**VOLUME TWO – DOCUMENTATION – PART I**

- 9 INTRODUCTION**
- 10 DOCUMENTATION MATERIALS FOR AUDIT, REVIEW, AND COMPILATION ENGAGEMENTS**

**INDEX**

**VOLUME THREE – DOCUMENTATION – PART II**

- 11 TIME CONTROL DOCUMENTS**
- 12 SUPERVISION AND REVIEW CHECKLISTS**
- 13 CORRESPONDENCE LIST**
- 14 STANDARD WORKING PAPERS PACKAGE**

**INDEX**



## **VOLUME FOUR – REPORTING**

- 15 INTRODUCTION**
  - 16 FIRM POLICIES AND PROCEDURES**
  - 17 FINANCIAL STATEMENT FORMAT, DISCLOSURES AND TERMINOLOGY**
  - 18 AUDITORS' REPORTS, AND FINANCIAL STATEMENTS AND NOTES CHECKLISTS**
  - 19 REPORTING ON AUDITED FINANCIAL STATEMENTS**
  - 20 REPORTING ON COMPILATION AND REVIEW ENGAGEMENTS**
  - 21 CONSULTING SERVICES**
  - 22 CONTINUING PROFESSIONAL EDUCATION**
- INDEX**







**CHAPTER 15**  
**INTRODUCTION**  
**Table of Contents**

<b><u>Section</u></b>		<b><u>Page</u></b>
15.000	PURPOSE	15-3
15.100	APPLICATION	15-3
15.200	MINIMUM REFERENCE MATERIALS	15-3
15.300	TABLE OF CONTENTS AND TOPICAL INDEX	15-4





## CHAPTER 15

### INTRODUCTION

#### 15.000 PURPOSE

**15.001** This volume is designed to help firm professional personnel complete the reporting phase of audit and accounting engagements. The contents and guidance included in this volume are intended for uniform application within the firm. The guidance includes both suggested firm policies and generally accepted accounting principles (GAAP). All suggested firm policies should be reviewed by firm management and modified as necessary. Modification of policies and procedures should be approved by the engagement partner. Documentation of significant departures from policies and procedures should include the facts of the particular situation and reference to appropriate authoritative support.

#### 15.100 APPLICATION

**15.101** This volume is intended for use in connection with GAAP-basis financial statements of nonpublic commercial and industrial corporations. It does not suggest guidance for reporting on specialized businesses and industries. Included below are references to sources for consultation concerning these specialized situations.

#### 15.200 MINIMUM REFERENCE MATERIALS

**15.201** *AICPA Professional Standards, Volume 1: U.S. Auditing Standards* (including Statements on Auditing Standards, Auditing Interpretations, and Statements on Standards for Attestation Engagements); *Volume 2: Accounting and Review Services* (including Statements on Standards for Accounting and Review Services, Ethics, By-laws, International Accounting, International Auditing, Consulting Services, Quality Control, and Tax Practice).

**15.202** Financial Accounting Standards Board (FASB), *Accounting Standards — Current Text* (Volumes 1 and 2). This contains the authoritative pronouncements currently in effect that have been issued by the Accounting Principles Board (APB) and the Financial Accounting Standards Board (FASB).

**15.203** FASB *EITF Abstracts*. This loose-leaf publication contains the consensuses reached by the FASB's Emerging Issues Task Force on various accounting issues. EITF consensuses are in *category c* in the GAAP hierarchy. (Sections 1.505 and 1.506 in Chapter 1 list selected EITF consensuses that have wide applicability and relevance.)

**15.204** *AICPA Technical Practice Aids (TPAs)*. This publication includes the TPAs (inquiries and their related responses from the AICPA Technical Information Division Staff to specific accounting, auditing, disclosure, and reporting matters raised by practitioners) as well as the Statements of Position and Practice

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Bulletins issued by the AICPA Accounting Standards Division and Auditing Standards Division. Statements of Position are *category b* in the GAAP hierarchy, Practice Bulletins are *category c*, and TPAs are in the "other literature" category. (See Chapter 1, section 1.500 for a discussion of the GAAP hierarchy.)

**15.205** *AICPA Industry Audit and Accounting Guides*. These Guides cover a wide range of specialized industries and should be used in an audit of entities that operate in the respective industries. AICPA Industry Audit and Accounting Guides are *category b* in the GAAP hierarchy.

**15.206** *AICPA Accounting Trends and Techniques*. This publication provides the latest trends in corporate financial statement reporting and in auditor's reports by surveying the annual reports of 600 industrial and merchandising corporations.

### **15.300 TABLE OF CONTENTS AND TOPICAL INDEX**

**15.301** An alphabetical topical index is included at the end of this and the other three volumes of this Manual. The index is based on key words included in marginal topical headings.





**CHAPTER 16**  
**FIRM POLICIES AND PROCEDURES**

**Table of Contents**

<b><u>Section</u></b>		<b><u>Page</u></b>
16.000	APPROACH TO DRAFTING FINANCIAL STATEMENTS	16-3
16.100	RESPONSIBILITIES AND WORK ORGANIZATION	16-4
16.101	Trial Balance Preparation	16-4
16.101	Trial Balance — Illustration No. 16-1	16-4
16.102	Management's Review and Approval of Financial Statements	16-5
16.103	Meeting Users' Needs	16-5
16.104	Financial Statement Format, Disclosures, and Terminology	16-5
16.105	Reference Materials Research	16-6
16.106	Reporting Checklist	16-6
16.107	Modifying the Financial Statements	16-6
16.108	Statement of Cash Flows Working Paper	16-6
16.108	Statement of Cash Flows Working Paper — Illustration No. 16-2	16-7
16.109	Completing the Financial Statements	16-10
16.200	APPROACH TO WRITING NOTES	16-10
16.201	Effective Writing Techniques	16-10
16.204	Major Notes Categories	16-10

## CHAPTER 16

### FIRM POLICIES AND PROCEDURES

#### Table of Contents (Continued)

<b><u>Section</u></b>		<b><u>Page</u></b>
16.207	Determining Disclosure Requirements	16-11
16.209	Outlining the Contents of Notes	16-11
16.210	Using Prior Year or Illustrative Notes	16-11
16.211	Reading Completed Financial Statements and Notes	16-11
16.212	Completing the Auditor's Report and the Financial Statements and Notes Checklists	16-12
16.213	Other Notes Matters	16-12
16.300	APPROACH TO REPORT WRITING	16-12
16.301	Reporting Limitations and Problems	16-12
16.400	APPROACH TO REPORT PROCESSING AND REVIEW	16-13
16.401	Approach to Report Processing — Illustration No. 16-3	16-13
16.402	The Engagement Performance Review Checklist	16-14
16.403	Technical Review Checklist	16-14
16.405	Financial Statement Control Form	16-15
16.407	Signing the Report	16-15
16.408	Proofreading Procedures	16-15



## CHAPTER 16

### FIRM POLICIES AND PROCEDURES

#### 16.000 APPROACH TO DRAFTING FINANCIAL STATEMENTS

**16.001** Financial statements are the means by which the information accumulated and processed in financial accounting is periodically communicated to those who use it. They are designed to serve the needs of a variety of users, particularly owners and creditors. Through the financial accounting process, the myriad and complex effects of the economic activities of an enterprise are accumulated, analyzed, quantified, classified, recorded, summarized, and reported as information of two basic types:

1. Financial position (or balance sheet), which relates to a point in time;
2. Changes in financial position (or comprehensive income), which relate to a period of time.

**16.002** Notes to the statements are an integral part of the financial statements. Notes are used to explain headings, captions, or amounts in the statements, or to present information that cannot be expressed in monetary terms. They also provide a description of accounting policies followed.

**16.003** There are important characteristics and limitations of the financial accounting process and financial statements. They follow in condensed form:

- Financial statements are primarily historical.
- Financial statements are designed to serve the common needs of a variety of users.
- Financial statements are fundamentally interrelated.
- Information is classified according to presumed needs of users.
- Financial statements summarize large numbers of transactions.
- Financial statements are expressed in terms of the monetary unit of the country in which they are issued; changes in purchasing power are not reflected.
- Several different measurement bases are used in financial statements; current value or liquidation value may sometimes be used but they are not primary measurement bases.
- Generally accepted accounting principles (GAAP) basis rather than the cash basis is preferred.
- As far as possible, estimates and judgments are related to data derived from verifiable events.
- The economic substance of transactions should usually prevail over legal form.

- Financial statement users are presumed to be generally familiar with business practices, the terminology of accounting and the nature of the information reported.

**16.004** The presentation of similar financial data and statements may vary according to the specific needs of the user. Because users' needs, as well as facts and circumstances, change with time, it will be rare for financial statement format, terminology, and notes to remain unchanged from year to year. While use of the illustrative financial statements in Chapter 18 will facilitate the preparation of annual financial statements, they are not a substitute for common sense and professional judgment in each individual circumstance.

## 16.100 RESPONSIBILITIES AND WORK ORGANIZATION

### Trial Balance Preparation

**16.101** For firms that do not use a PC for preparation of workpapers, one of the two following methods can be used; the lead sheet method or the working trial balance method. Use of either of these methods should result in final adjusted account balances and groupings for inclusion in financial statements. Under the lead sheet method, financial statement classifications will be summarized on the lead sheets and summary trial balance. Under the working trial balance method, financial statement classifications should be summarized in red pencil on the right side of the working trial balance to be transferred to prior years' financial statements or to copies of the illustrative financial statements in Chapter 18. Illustration No. 16-1 outlines the firm's approach to drafting financial statements.

#### Illustration No. 16-1

<u>PROCEDURE</u>	<u>RESPONSIBILITY</u>
1. Summarize account balances into financial statement classifications.	1. Staff or in-charge.
2. Consider the needs of statements' users.	2. In-charge.
3. Read the classifications and disclosures section of this volume (Chapter 17).	3. Staff and in-charge.
4. Research AICPA and FASB pronouncements and applicable industry or regulatory agency accounting and reporting reference materials for reporting or disclosure problems.	4. In-charge.
5. Read and complete the Auditor's Report and Financial Statements and Notes Checklists. (Chapter 18)	5. Staff.

◆ **Illustration No. 16-1 (continued)**

<u>PROCEDURE</u>	<u>RESPONSIBILITY</u>
6. Research any unfamiliar disclosure requirements.	6. Staff.
7. Prepare statement of cash flows working paper. (section 16.108 and Chapter 14, section 14.129)	7. Staff.
8. Transfer classified balances from lead sheet or working trial balance to financial statements.	8. Staff.

**Management's Review and Approval of Financial Statements**

**16.102** The basic financial statements, notes to financial statements, and supplementary information are representations of the client company's management. Final decisions as to the form and content of financial statements rest with management. All adjustments, except for routine account combinations and reclassifications should be approved by management before the report is issued. The engagement partner should review the drafts of the financial statements with management before it is finalized and obtain client approval of the suggested format, disclosures, and terminology.

**Meeting Users' Needs**

**16.103** While financial statements are management's representations, they are presented primarily for the information of a certain user or groups of users. In addition to containing all disclosures required by GAAP, the financial statement format, terminology, and classifications should be presented in the way that best meets the users' needs. While industry or regulatory agency guides are available for assistance with many financial statement formats, other situations may require careful consideration of the circumstances and the informational needs of the user. For example, commercial and industrial companies will normally present current asset and liability classifications. Not-for-profit enterprises normally do not require such classifications. Manufacturing companies will ordinarily present statements of earnings with multisteps, i.e., sales and costs of sales are presented to derive gross profit from which selling, general, and administrative expenses are deducted to derive earnings or losses from operations. For other nonmanufacturing enterprises, however, it may not be necessary to derive gross profit and earnings from operations, in which cases a single-step statement, i.e., total revenues less all costs and expenses to derive net earnings, may be appropriate.

**Financial Statement Format, Disclosures, and Terminology**

**16.104** Chapter 17 includes discussions of suggested disclosures for each financial statement classification. These policies should be reviewed when preparing financial statements.

## Reference Materials Research

**16.105** Any reporting or disclosure problems should be researched in the appropriate reference materials prior to drafting the financial statements. Before preparing financial statements for clients in specialized industries, any applicable accounting and auditing guides or other reference materials should be researched for financial statement disclosure requirements. Conformity with industry requirements will be necessary to meet users' needs in such specialized industries.

## Reporting Checklist

**16.106** The Auditors' Reports and the Financial Statements and Notes Checklists (Chapter 18) should be completed for all full-disclosure accounting and auditing services engagements. The Checklists should be read by the staff person preparing the financial statements and notes. This staff person may be the in-charge, but ordinarily the responsibility for drafting financial statements and writing notes should be assigned to less experienced staff. Substantial on-the-job training opportunities are available during the conduct of an engagement. An inexperienced assistant or semi-senior staff accountant can receive substantial training benefits by drafting financial statements and writing notes. In any event, the in-charge should review the work of the assigned staff person. The Checklists should be completed by the in-charge and reviewed by the engagement partner. The partner should review the Checklists to determine that all questions have been appropriately answered and consideration given to all disclosures necessary in the circumstances.

## Modifying the Financial Statements

**16.107** After reviewing Chapter 17 and the Checklists, the format, terminology, and classifications used in the financial statements should be modified by a staff person to appropriately disclose the current circumstances. Any significant changes from the prior year or the illustrative financial statements in Chapter 17 should be approved by the in-charge and the engagement partner before staff begins modification.

## Statement of Cash Flows Working Paper

**16.108** Illustration No. 16-2 is a sample statement of cash flows working paper. After final adjusting entries have been posted to the working trial balance or lead sheet summaries, this or a similar working paper should be prepared by the in-charge or staff person drafting the financial statements. A statement of cash flows working paper is included in the standard working papers package contained in Chapter 14, section 14.129 of this Manual. Preparation of a statement of cash flows working paper will not only aid the preparer in organizing and completing the preparation of the statement of cash flows, but will also enable the engagement partner to easily trace and review the work done by staff.











## Completing the Financial Statements

**16.109** As mentioned earlier, if the firm does not use a PC for the preparation of workpapers or financial statements, the classified account balances from the lead trial balance or from the working trial balance, and from the statement of cash flows working paper, should be transferred to the financial statements. All transferred numbers should be footed and cross-referenced to other locations in the financial statements. At a minimum, the financial statements should be rounded to the nearest whole dollar. In financial statements of larger clients, the engagement partner may approve rounding to the nearest hundreds or thousands of dollars.

## 16.200 APPROACH TO WRITING NOTES

### Effective Writing Techniques

**16.201** Effective writing techniques include the logical organization of the writing, use of specific words and short sentences, and use of the active instead of passive voice. The approach to effective writing is comprised essentially of three steps:

- Create the writing.
- Edit the writing.
- Rewrite the edited draft.

**16.202** These effective writing techniques should be used to create readable, meaningful notes to financial statements. The notes should be brief, sentences short, and terminology precise and understandable. The notes should also be free of repetitive or redundant wording.

**16.203** Notes, like financial statements, are representations of management. When notes are written for the approval of a client company, they must be written as the client would prepare them.

### Major Notes Categories

**16.204** Note 1 should always be the summary of significant accounting policies. The purpose of the summary of significant accounting policies is to identify and describe the accounting principles and related methods that have a material effect on the financial position, results of operations, and statement of cash flows of the company. The principles and methods should be consistently followed; changes should be disclosed in other notes. Common categories include the following:

- The nature of the company's business and its organizational form, if not otherwise evident.
- Specific or unusual applications of alternative accounting principles.
- Accounting principles and methods that are not addressed by most sources or used by most businesses.
- Revenue recognition methods.
- Reasons for, and methods of, deferring costs to future periods.



- Carrying basis of certain assets and liabilities.
- Policy for determining cash equivalents for statement of cash flows.

**16.205** The summary of significant accounting policies should include those policies that are general in their nature and are applied consistently from year to year. The summary will ordinarily not include schedules or numbers relating to financial statement classifications and ordinarily will not discuss changes in accounting principles. Details of the composition of financial statement classifications and changes in accounting principles should be presented in separate notes.

**16.206** Ordinarily, details presented in the summary of significant accounting policies need not be repeated in other related notes. Certain policies may be repeated, however, for emphasis of a particular matter.

### **Determining Disclosure Requirements**

**16.207** The Auditors' Reports and the Financial Statements and Notes Checklists in Chapter 18 include references to appropriate sections of the FASB *Accounting Standards — Current Text* and the AICPA *Professional Standards*. These authoritative sources comprise a substantial part of financial statement disclosure requirements. Other disclosures may, however, be required by certain laws or regulations. The auditor should consider whether the disclosures enumerated in those standards, including those in AU 317 dealing with laws and regulations, were made.

**16.208** Financial statement disclosures also include selecting the appropriate format, classifications, and terminology. Determining the adequacy of disclosures in each set of facts and circumstances requires the careful exercise of professional judgment.

### **Outlining the Contents of Notes**

**16.209** A detailed outline, including descriptions and amounts of disclosures, should be prepared for major note categories. The outline will insure that all necessary disclosures are made and that they are presented logically and concisely.

### **Using Prior Year or Illustrative Notes**

**16.210** Comparing a detailed outline to prior year or illustrative notes will allow staff to make modifications for a client's current circumstances, in minimum time. Editing and rewriting will produce a set of comprehensive, organized notes.

### **Reading Completed Financial Statements and Notes**

**16.211** After the preparer has completed the financial statements and notes, they should be set aside for a brief period of time. Before submission to a reviewer, they should be read to identify and make final editing changes. All persons preparing or revising financial statements and notes should be satisfied that, to the best of their knowledge and ability, the statements and notes *could* be released without further review or modification. This commitment to quality by each staff person will enable the firm to provide clients the best product possible.

## **Completing the Auditors' Reports and the Financial Statements and Notes Checklists**

**16.212** The in-charge should review the financial statements and complete the Auditors' Reports and the Financial Statements and Notes Checklists after the statements are drafted and the notes have been written. The engagement partner should review the Auditors' Reports and the Financial Statements and Notes Checklists during the engagement review.

### **Other Notes Matters**

**16.213** After the summary of significant accounting policies, the notes should be arranged in the approximate order of the financial statement classifications. Notes relating to several classifications, e.g., related parties, those affecting the financial statements as a whole, e.g., contingencies, or those relating to other significant events or transactions, e.g., subsequent events, are ordinarily presented last.

**16.214** Notes should be referenced to applicable classifications in the balance sheet and statement of earnings. Note references are not ordinarily placed on the statement of cash flows unless necessary for emphasis of a special matter or for referencing the required noncash investing or financing activities information.

## **16.300 APPROACH TO REPORT WRITING**

### **Reporting Limitations and Problems**

**16.301** As discussed in Chapter 2, section 2.200, the nature of the engagement is initially determined by obtaining a signed engagement letter from the client. The scope of an engagement is designed to accomplish the objectives that will enable the firm to express the desired level of assurance. Assuming there are no limitations on the evidence gathering process, and that evidence gathered is sufficient to support management's assertions in the financial statements, the firm will issue the standard report for the level of service being performed. Limitations on the scope of the engagement or incomplete, unsatisfactory, or incorrect presentation and disclosure of management assertions will require modification of the standard report.

**16.302** Upon identification of a reporting problem, the in-charge should communicate the details of the problem to the engagement partner. The accountant first should determine his or her professional responsibilities and, second, within this framework, attempt to resolve the problem in the best interests of the client. The engagement partner should immediately contact the client to discuss the impact of the potential reporting problem and its planned resolution. Upon resolution of the reporting problem, the engagement partner should prepare a memorandum that contains the following information:

- Complete details of the circumstances causing the report modification.
- The date of the communication of the reporting problem to the client and the nature of the items discussed during that communication.
- Details of additional procedures performed to resolve or mitigate the reporting problem.

- The partner's conclusion about the impact of the problem on the engagement report.
- Results of any additional procedures performed.

**16.400 APPROACH TO REPORT PROCESSING AND REVIEW**

**16.401** Illustration No. 16-3 contains a suggested approach to report processing and review. Report processing and review is the culmination of quality control procedures that have occurred during the performance of the engagement and preparation of the financial statements and report. To maintain the quality of work, and to ensure that it is done efficiently and within the constraints of client deadlines, control over the report processing phase of an engagement is essential.

**Illustration No. 16-3**

<u>PROCEDURE</u>	<u>RESPONSIBILITY</u>
1. Approve and initial assistants' working papers, approve report and financial statements, prepare and sign checklists: <ul style="list-style-type: none"> <li>a. Auditors' Reports and the Financial Statements and Notes Checklists.</li> <li>b. Engagement Performance Review Checklist.</li> <li>c. Technical Review Checklist.</li> <li>d. Financial Statement Control Form.</li> </ul>	1. In-Charge
2. a. Approve and initial tax-related working papers. b. Approve tax provision and liability computations. c. Prepare Tax Accrual/Provision Checklist.	2. Tax Department
3. a. Approve and initial working papers prepared by in-charge; approve report and financial statements. b. Approve checklists: <ul style="list-style-type: none"> <li>i. Tax Accrual/Provision Checklist.</li> <li>ii. Engagement Performance Review Checklist.</li> <li>iii. Auditors' Reports and the Financial Statements and Notes Checklists.</li> <li>iv. Technical Review Checklist.</li> </ul> c. Review tentative financial statements with client.	3. Engagement Partner
4. a. Approve the engagement performance and report preparation by preparing Financial Statement Control Form.	4. Independent Report Reviewer
5. a. Type and proof report. b. Sign Financial Statement Control Form.	5. Typing Department

**Illustration No. 16-3 (continued)**

<u>PROCEDURE</u>	<u>RESPONSIBILITY</u>
<ul style="list-style-type: none"> <li>c. Obtain in-charge and partner approval of financial statements and report drafts.</li> </ul>	
<ul style="list-style-type: none"> <li>6. a. Prepare report copies.</li> <li>    b. Collate, assemble and bind.</li> </ul>	6. Production Department
<ul style="list-style-type: none"> <li>7. a. Complete Engagement Performance Review Checklist.</li> <li>    b. Determine that all open items are cleared and "to do" lists destroyed.</li> <li>    c. Sign transmittal letter.</li> <li>    d. Complete and sign Financial Statement Control Form for final release.</li> <li>    e. Deliver report.</li> <li>    f. Return Financial Statement Control Form and extra report copies to Typing Department for filing.</li> </ul>	7. Engagement Partner

**The Engagement Performance Review Checklist**

**16.402** The Engagement Performance Review Checklist should be completed to document the review of all engagements. Foregoing the engagement review function must be approved by the firm or office accounting and auditing partner and documented in a memo to the engagement file. Any problems discovered in the review should be discussed with the engagement partner. Resolution of the problems should be documented in separate memoranda.

**Technical Review Checklist**

**16.403** The purpose of the Technical Review Checklist (Chapter 12, section 12.504) is to ensure that the professional standards of performance and reporting have been met on each engagement. The independent report reviewer has responsibility to, among other things, review the financial statements for appropriate form and content and read the auditor's (accountant's) report for appropriateness and conformity with professional standards.

**16.404** The technical review should be performed by a manager or partner not having direct engagement management responsibility.

## Financial Statement Control Form

**16.405** A Financial Statement Control Form is included in Chapter 12, section 12.604. This checklist should accompany drafts of financial statements, notes, and reports for all engagements. As explained in Illustration No. 16-3, final disposition of the Financial Statement Control Form is the responsibility of the engagement partner. In completing the Financial Statement Control Form, the engagement partner has the responsibility for:

- Making sure all processing levels are completed and signed.
- Completing the report release questions.
- Releasing the report.

**16.406** Uneven work loads, engagement completion delays and other problems will occasionally cause report processing schedules to be altered. The in-charge has primary responsibility for controlling the processing function and should communicate with the engagement partner whenever unexpected delays occur. The engagement partner should communicate with the client to apprise them of any processing difficulties. If client deadlines cannot be altered, the engagement partner should request the firm or office managing partner to allow prioritizing of the report's processing.

## Signing the Report

**16.407** As indicated in the Financial Statement Control Form, the engagement partner is the primary authorized signer of an engagement report. Signing responsibilities can be delegated to other partners, but in no event should a staff person sign the firm name to an engagement report.

## Proofreading Procedures

**16.408** All final report drafts should be proofread by a person other than the preparer. Proofreading procedures may involve two persons and should include the following:

- Read the entire draft from beginning to end.
- Cross-reference all interrelated numbers.
- Refoot all column totals.
- Recalculate any computations.
- Using the draft, read aloud to another person the contents specifically identifying the capitalization policies, indentation policies, spacing policies, format considerations, punctuation and placement of dollar signs.
- Correction of all errors found during the proofreading process should be checked by the original proofreader.







**CHAPTER 17**  
**FINANCIAL STATEMENT FORMAT, DISCLOSURES,  
AND TERMINOLOGY**

**Table of Contents**

<b><u>Section</u></b>		<b><u>Page</u></b>
17.000	GENERAL	17-7
17.001	Name of Entity	17-7
17.002	Referencing Notes	17-7
17.003	Comparative Notes	17-7
17.005	Materiality	17-8
17.006	References to Applicable Pronouncements	17-8
17.007	Disclosure Principles	17-8
17.010	Management Representations	17-9
17.100	CONSOLIDATED AND COMBINED PRESENTATIONS	17-9
17.102	Consolidation Disclosures	17-9
17.104	Unconsolidated Subsidiaries	17-9
17.107	Minority Interests	17-10
17.108	Goodwill	17-11
17.109	Income Taxes on Undistributed Earnings of More Than 50%-Owned Subsidiaries	17-11
17.110	Combined Financial Statements	17-11

## CHAPTER 17

### FINANCIAL STATEMENT FORMAT, DISCLOSURES, AND TERMINOLOGY

#### Table of Contents (Continued)

<b><u>Section</u></b>		<b><u>Page</u></b>
17.111	Business Combinations	17-12
17.111	Pooling-of-Interests Accounting	17-12
17.112	Purchase Accounting	17-13
17.113	Disclosures	17-13
17.114	Changes in Methods of Accounting	17-15
17.115	Subsequent Events	17-15
17.117	Contingent Consideration	17-15
17.119	Disclosure Illustrations	17-16
17.200	RELATED-PARTY TRANSACTIONS	17-17
17.206	Disclosure of Major Customers	17-18
17.300	ACCOUNTING CHANGES	17-18
17.301	Types of Accounting Changes	17-18
17.302	Changes in Accounting Principles	17-18
17.306	Restatements of Prior Periods	17-20
17.310	Changes in Reporting Entities	17-20
17.311	Changes in Accounting Estimates	17-21
17.312	Correction of an Error in Previously-Issued Financial Statements	17-21
17.314	Historical Summaries of Financial Information	17-22
17.400	SUBSEQUENT EVENTS	17-22
17.500	ASSETS AND LIABILITIES DISCLOSURES — GENERAL	17-23
17.501	Current Assets	17-23

**CHAPTER 17**  
**FINANCIAL STATEMENT FORMAT, DISCLOSURES,**  
**AND TERMINOLOGY**

**Table of Contents (Continued)**

<u>Section</u>		<u>Page</u>
17.502	Contra Accounts	17-23
17.503	Cash and Cash Equivalents	17-23
17.504	Restricted Cash	17-23
17.505	Overdrafts	17-23
17.506	Compensating Balances	17-23
17.508	Investments in Debt and Equity Securities	17-24
17.510	Applicability	17-24
17.511	Disclosures	17-25
17.513	Offsetting Assets and Liabilities	17-26
17.514	Financial Instruments	17-26
17.516	Trade Notes and Accounts Receivable	17-27
17.517	Receivables From Officers, Directors, Shareholders, Affiliated Entities and Employees	17-27
17.518	Notes Receivable, Other Notes, and Accounts Receivable	17-27
17.519	Installment Accounting Method	17-27
17.520	Receivables Financing	17-27
17.521	Allowance for Uncollectible Accounts	17-27
17.523	Inventories	17-28
17.527	LIFO Inventories	17-28
17.530	Prepaid Expenses	17-29
17.531	Investments In and Advances To Affiliated Entities	17-29

## CHAPTER 17

### FINANCIAL STATEMENT FORMAT, DISCLOSURES, AND TERMINOLOGY

#### Table of Contents (Continued)

<u>Section</u>		<u>Page</u>
17.534	Presentation	17-29
17.535	Fiscal Years	17-30
17.536	Losses on Investments	17-30
17.537	Dividends	17-30
17.538	Other Disclosures	17-30
17.542	Property and Equipment	17-30
17.545	Leases — Lessees	17-31
17.547	Operating Leases	17-31
17.550	Capital Leases	17-32
17.553	Leases — Lessors	17-32
17.554	Sales-Type and Direct Financing Leases	17-32
17.555	General Disclosures Under Leasing Arrangements	17-33
17.556	Sales-Type and Direct Financing Leases	17-33
17.557	Operating Leases	17-33
17.558	Leveraged Leases	17-33
17.563	Capitalized Interest	17-35
17.567	Intangible Assets	17-36
17.568	Other Assets	17-36
17.571	Current Liabilities	17-37
17.572	Notes Payable	17-37
17.574	Accounts Payable	17-37



**CHAPTER 17**  
**FINANCIAL STATEMENT FORMAT, DISCLOSURES,**  
**AND TERMINOLOGY**

**Table of Contents (Continued)**

<u>Section</u>		<u>Page</u>
17.575	Accrued Expenses	17-37
17.576	Compensated Absences	17-37
17.578	Income Taxes	17-38
17.579	Dividends Payable	17-38
17.580	Estimated Liabilities	17-38
17.581	Life Insurance Policy Loans	17-38
17.582	Long-Term Liabilities	17-39
17.582	Long-Term Debt	17-39
17.584	Unconditional Purchase Obligations	17-39
17.587	Imputed Interest	17-40
17.588	Contingencies	17-40
17.591	Litigation	17-41
17.592	Commitments	17-41
17.593	Retirement and Pension Plans	17-42
17.595	Profit-Sharing Plans	17-42
17.596	Deferred Compensation Contracts	17-43
17.597	Stock Option and Stock Purchase Plans	17-43
17.600	SHAREHOLDERS' EQUITY	17-44
17.603	Capital Stock	17-45
17.604	Additional Paid-In Capital	17-45

## CHAPTER 17

### FINANCIAL STATEMENT FORMAT, DISCLOSURES, AND TERMINOLOGY

#### Table of Contents (Continued)

<u>Section</u>		<u>Page</u>
17.605	Treasury Stock	17-45
17.606	Retained Earnings	17-46
17.607	Dividends	17-46
17.700	STATEMENTS OF EARNINGS	17-46
17.702	Sales	17-46
17.704	Costs of Sales	17-46
17.706	Losses on Debt and Equity Securities	17-46
17.707	Operating Expenses	17-46
17.708	Income Taxes	17-47
17.709	Tax-Exempt Entities	17-47
17.710	Other Income	17-47
17.711	Other Expenses	17-47
17.712	Research and Development Costs	17-47
17.713	Extraordinary Items	17-48
17.717	Prior-Period Adjustments	17-48
17.719	Discontinued Operations of a Segment of a Business	17-49
17.725	Earnings-Per-Share Data	17-50
17.727	Simple Capital Structure	17-50
17.728	Complex Capital Structure	17-50
17.800	SEGMENTS OF A BUSINESS ENTERPRISE	17-52
17.900	STATEMENT OF CASH FLOWS	17-52

## CHAPTER 17

### FINANCIAL STATEMENT FORMAT, DISCLOSURES, AND TERMINOLOGY

#### 17.000 GENERAL

##### Name of Entity

**17.001** The exact legal name of the entity should be used in the financial statements. If the entity is a partnership, proprietorship, or an S corporation, these terms should be included wherever references are made to the entity's name. In a financial statement heading, the name would appear as follows:

XYZ COMPANY  
(an S corporation)  
STATEMENTS OF EARNINGS  
YEARS ENDED DECEMBER 31, 19X AND 19W

##### Referencing Notes

**17.002** Because the notes are an integral part of the financial statements, financial statement items on the balance sheet and statements of earnings should be referenced to the notes wherever possible. References to notes should be included in the statement of cash flows only to emphasize a special matter or for referencing the required noncash investing or financing activities information. Because Note 1 ordinarily contains disclosures of significant accounting policies that are relatively uniform from year to year and that may affect numerous classifications, Note 1 references are ordinarily not placed on the face of the financial statements.

##### Comparative Notes

**17.003** Notes to comparative financial statements should reflect disclosures applicable to all periods being presented. Numerical data presented in the notes should be presented in a parallel tabulation.

**17.004** Any prior years' information no longer significant should be deleted. Such data would ordinarily include subsequent events recognized in the current period, changes in available tax carryovers, contingencies and commitments, assets subject to lien, and defaults on debt.

## Materiality

**17.005** Section 10.600 of Chapter 10 includes discussions of concepts of materiality and tolerable error amounts. In determining which financial statement items to combine or disclose separately, and which other financial statement and note disclosures are necessary, the general materiality concepts should apply. Factors to be considered in assessing materiality include the relative dollar amount of the item, the importance to the client company of the area being considered, e.g., inventories in a manufacturing company, and the number of other financial statement items affected. The requirements of generally accepted accounting principles (GAAP) and generally accepted auditing standards (GAAS) are based on these concepts of materiality. The standards do not apply in immaterial situations. The primary guideline in evaluating the adequacy of financial statement disclosures, however, is whether the statements include all information that is necessary to evaluate financial position and results of operations.<sup>1</sup> In other words, good disclosure may require the disclosure of facts or conditions in certain circumstances that may not be material or may not be required by professional standards.

## References to Applicable Pronouncements

**17.006** This chapter is presented to illustrate frequently used disclosures that should appear in the financial statements and in the notes to the financial statements to meet the requirements of GAAP and GAAS for nonpublic companies. It does not include references to rules contained in the SEC's Regulation S-X, Regulation S-K, Regulation S-B, Financial Reporting Releases, or Staff Accounting Bulletins. This chapter does not deal with reporting problems of specialized industries and not-for-profit organizations.<sup>1</sup> Users should refer to the AICPA *Professional Standards*, FASB *Accounting Standards*, applicable AICPA Industry Audit and Accounting Guides, Statements of Position, Consensuses of the FASB Emerging Issues Task Force, and accounting and auditing interpretations to supplement this manual.

## Disclosure Principles

**17.007** The financial statements and notes to financial statements should contain all disclosures necessary to prevent them from being misleading. Disclosure considerations are affected by the account classification decisions, the format of the financial statements, the amount of detail in the statements, terminology, and the contents of the notes to the financial statements.

**17.008** When considering items for disclosure, whether or not specifically required in the authoritative pronouncements, any situation impacting the future operations of the company (including the ability of the company to satisfy its creditors) should be disclosed.

**17.009** Explanatory disclosures should generally be excluded from the face of the statements. Such disclosures should become a part of the notes to financial statements. The disclosures should be presented concisely and logically.

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<sup>1</sup> Accounting, reporting, and audit issues of not-for-profit organizations are discussed in the AICPA Integrated Practice System, *Not-for-Profit Organizations Audit Manual* (Product No. 008864).

## Management Representations

**17.010** The financial statements and notes are the representations of management in the form of assertions. They should not include the accountant's commentary or other inferences that relate to the nature of the engagement.

## 17.100 CONSOLIDATED AND COMBINED PRESENTATIONS

**17.101** Consolidation of all majority-owned subsidiaries is required by GAAP unless control is temporary or it does not rest with the majority owner. Consolidated financial statements are required when the controlling financial interest rests directly or indirectly in one of the affiliated companies. A controlling financial interest is ordinarily a majority voting interest and direct or indirect ownership of more than 50% of the outstanding voting shares of another company. Exceptions to the 50% ownership rule include temporary ownership or where control is being exercised by a receiver for a company in reorganization or bankruptcy.

## Consolidation Disclosures

**17.102** Note 1 to the consolidated financial statements (generally titled "Summary of Significant Accounting Policies") should contain disclosure of the consolidation policies. In addition, the financial statement titles and auditor's (accountant's) report should include the word "consolidated." A description of the consolidated companies, and accounting principles in consolidation, should be included in the disclosure. Any changes in the basis of preparing consolidated statements should be disclosed. The change should be applied retroactively and requires restatement of the prior year's statements. The following is an example of disclosure of a consolidation policy.

### Principles of Consolidation

The consolidated financial statements include the accounts of DEF Company, a wholly-owned subsidiary. All material intercompany balances and transactions have been eliminated.

**17.103** For majority-owned subsidiaries that are consolidated as a result of SFAS 94, *Consolidation of All Majority-Owned Subsidiaries* (AC C51), that were unconsolidated in financial statements for fiscal years 1986 and 1987, disaggregated information required by Accounting Principles Board (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, (AC I82) must still be presented in the consolidated financial statements or in the notes.

## Unconsolidated Subsidiaries

**17.104** Investments in 20%- to 50%-owned unconsolidated subsidiaries and other affiliated companies over which the parent exercises significant influence, should be recorded by the equity method and presented separately from other investments. Under the equity method, the investment in unconsolidated subsidiaries is adjusted for the parent's share of undistributed earnings or losses since acquisition. Periodic earnings and losses adjusted for amortization of the difference between the cost of the investment and the equity in net assets at the date of acquisition, any adjustments for preacquisition contingencies, and any intercompany gains or losses should be presented as a separate line item in the earnings statements.

**17.105** Foreign subsidiaries operating under uncertainties, exchange restrictions, and other controls that cast doubt upon the realization of earnings of the subsidiary should be accounted for under the cost method. The details of any foreign operations included in consolidated financial statements should be disclosed. Such disclosures should include a summary of the assets, liabilities, income and expenses of foreign subsidiaries for the year, and the parent company's equity in those amounts. The disclosures can be made in the notes or in separate statements.

**17.106** Earnings from a subsidiary should be included after the date of acquisition or up to the date of sale. Acquisitions through several block purchases of shares should be reflected by including the subsidiary in the consolidation at the total of the purchase costs. Preacquisition earnings applicable to the separate blocks of stock should be excluded from the single amount included in the earnings statement. Separate disclosure ordinarily should be made of the earnings of a subsidiary sold during the year, or of any gains or losses on disposition.

### Minority Interests

**17.107** Minority interests in the net earnings of subsidiaries should be classified as a deduction in the consolidated statements of earnings.

#### Consolidated Statements of Earnings — Minority Interests

	<u>19X</u>	<u>19W</u>
Earnings before income taxes and minority interests	\$ xxxx	\$ xxxx
Provision for income taxes	(xxxx)	(xxxx)
Earnings before minority interests	xxxx	xxxx
Minority interests in earnings of subsidiaries	(xxxx)	(xxxx)
Net Earnings	<u>\$ xxxx</u>	<u>\$ xxxx</u>

Minority interests in the equity of consolidated subsidiaries should be classified separately in the consolidated balance sheet between liabilities and consolidated stockholders' equity.



**Consolidated Balance Sheet —  
Minority Interests**

	<u>19X</u>	<u>19W</u>
Total Current Liabilities	\$xxxx	\$xxxx
Long-Term Debt	xxxx	xxxx
Deferred Tax Liability	xxxx	xxxx
Minority Interests in Subsidiaries	xxxx	xxxx
Stockholders' Equity:		

**Goodwill**

**17.108** Goodwill, which is the excess of the cost of the parent company's investment and its equity in the net assets of a purchased consolidated subsidiary at acquisition, should be allocated, wherever possible, to specific identifiable assets. Any unallocable amount should be classified separately in the balance sheet or notes as "Excess of Cost Over Net Assets of Purchased Companies." The excess, or goodwill, should be amortized in accordance with the provisions of APB Opinion No. 17, *Intangible Assets* (AC I60). Amortization policies should be disclosed in Note 1 to the financial statements.

**AUDIT ALERT**

If the economic downturn has adversely affected entities acquired in a business combination for which material amounts of goodwill were recorded, an impairment of goodwill may need to be recognized. When an impairment is recognized, the financial statements should disclose the reasons for the writedown in accordance with APB Opinion No. 17.

**Income Taxes on Undistributed Earnings of More Than  
50%-Owned Subsidiaries**

**17.109** If income taxes are not provided on undistributed earnings of more than 50%-owned subsidiaries included in pretax accounting income, the notes to the financial statements should disclose reasons therefor. Such reasons would ordinarily include the intent to reinvest the earnings or to distribute them in a tax-free liquidation. The disclosures should include the cumulative amount of undistributed earnings on which taxes have not been recognized. Such disclosures would normally not be required for equity investees or if a consolidated tax return is filed.

**Combined Financial Statements**

**17.110** Under certain conditions, the combined financial statements of commonly controlled companies are likely to be more meaningful than separate statements. Examples include:

- One individual owning a controlling interest in several corporations that have related operations.
- A group of unconsolidated subsidiaries.
- Companies under common management.

Disclosures in combined financial statements should include the same information that is required for consolidated financial statements.

### **Business Combinations**

**17.111 Pooling-of-Interests Accounting.** As discussed in detail in APB Opinion No. 16, *Business Combinations* (AC B50.105–.107) a business combination must be accounted for as a pooling of interests if all of the following conditions are met:

1. Each of the combining companies is autonomous and has not been a subsidiary or division of another corporation within two years before the plan of combination is initiated.
2. Each of the combining companies is independent of the other combining companies.
3. The combination is effected in a single transaction or is completed in accordance with a specific plan within one year after the plan is initiated.
4. A company offers and issues only common stock with rights identical to those of the majority of its outstanding voting common stock, in exchange for substantially all of the voting common stock interest of another company at the date the plan of combination is consummated.
5. None of the combining companies changes the equity interest of its voting common stock in contemplation of effecting the combination either within two years before the plan of combination is initiated, or between the dates the combination is initiated and consummated. Changes in contemplation of effecting the combination may include distribution to stockholders and additional issuances, exchanges, and retirements of securities.
6. Each of the combining companies reacquires shares of voting common stock only for purposes other than business combinations, and no company reacquires more than a normal number of shares between the dates the plan of combination is initiated and consummated.
7. The ratio of the interest of an individual common stockholder to those of other common stockholders in a combining company remains the same as a result of the exchange of stock to effect the combination.
8. The voting rights to which the common stock ownership interests in the resulting combined corporation are entitled are exercisable by the stockholders; the stockholders are neither deprived of nor restricted in exercising those rights for a period.
9. The combination is resolved at the date the plan is consummated and no provisions of the plan relating to the issue of securities or other consideration are pending.

- ◆
10. The combined corporation does not agree directly or indirectly to retire or reacquire all or part of the common stock issued to effect the combination.
  11. The combined corporation does not enter into other financial arrangements for the benefit of the former stockholders of a combining company, such as a guarantee of loans secured by stock issued in the combination, which in effect negates the exchange of equity securities.
  12. The combined corporation does not intend or plan to dispose of a significant part of the assets of the combining companies within two years after the combination other than disposals in the ordinary course of business of the formerly separate companies or to eliminate duplicate facilities or excess capacity.

**17.112 Purchase Accounting.** If any of the twelve conditions listed in section 17.111 is not met, purchase accounting (discussed in paragraphs 66–96 of APB Opinion No. 16 (AC B50.125–.166)) must be followed.

**17.113 Disclosures.** The principal disclosure requirements for business combinations accounted for as a pooling or as a purchase are summarized as follows:

- Method of accounting
  - Pooling — The notes should disclose the business combination has been accounted for as a pooling of interests.
  - Purchase — The notes should disclose the business combination has been accounted for as purchase.
- Names and descriptions of companies
  - Pooling — Disclose the names and description of combining companies.
  - Purchase — Disclose the names and descriptions of acquired companies.
- Description and number of shares of stock issued
  - Pooling — Describe the nature of capital stock and the number of shares issued.
  - Purchase — Describe the nature of the capital stock and the number of shares issued or issuable and the cost assigned to such shares.
- Periods covered by the current statements
  - Pooling — Disclose the basis of accounting for the pooling and any restatements of the prior periods. If the statements are not presented in comparative format, the notes to financial statements should include disclosures of revenues, extraordinary items, and net earnings of the companies for the preceding year on a combined basis.

The statement of earnings for the period in which a pooling of interests occurs should reflect the combining of the companies as of the beginning of the period.

Balance sheets for each of the combined companies should be presented on a combined basis as of the beginning of the period in which the pooling occurred.

**Purchase** — Disclose the period for which results of operations of the purchased company are included in the earnings statements of the acquiring corporation. Net earnings should be included from the date of acquisition.

- **Supplemental information**

**Pooling** — The notes to the financial statements should disclose a summary of the results of operations for each of the combining companies from the beginning of the period to the date the pooling occurred, or as of the end of an interim period nearest that date. Disclosures should include revenues, extraordinary items, net earnings, other changes in stockholders' equity, and the amount and manner of accounting for any intercompany transactions.

Increases or decreases in revenues, expenses, extraordinary items, net earnings and other changes in stockholders' equity excluded from the reported results of operations because of changes in the fiscal year of a combining company should be disclosed in the notes. The notes also should include reconciliations to any amounts reported by the acquiring company in previously-issued financial statements.

**Purchase** — The notes to financial statements of the acquiring company should include pro forma results of operations for the current year as if the company had been combined at the beginning of the period, and the results of operations for the immediately preceding period as if the companies had combined at the beginning of that period. Such disclosures can be omitted if the acquisition was at or near the beginning of the current period, if comparative financial statements are not presented, or if the company is a nonpublic enterprise.

The pro forma information should include, at a minimum, revenues, earnings before extraordinary items, net earnings and, if applicable, earnings per share.

- **Related expenses**

**Pooling** — Expenses or losses relating to a pooling should be charged against earnings of the combined corporation for the period in which the expenses are incurred.

**Purchase** — The cost of a purchase acquisition should be disclosed. Costs of registering and issuing equity securities should be deducted from the gross proceeds received from those securities. Indirect expenses related to acquisitions should be charged to earnings for the period.

FASB Technical Bulletin No. 85-5 states that when an acquiring company in a business combination closes some of its own facilities because they duplicate those purchased, the costs incurred would be charged to expense. If, however, duplicate facilities of the purchased company are closed, the costs incurred should be part of the acquisition cost.

### **Changes in Methods of Accounting**

**17.114** Changes in methods of accounting may be made by combining companies using the pooling-of-interests method if such change would have been appropriate for the separate companies. These changes should be made retroactively and prior period financial statements restated. The notes should disclose the effects of any adjustments by the combining companies adopting the same accounting practices. The effects on net assets and net earnings previously reported by the separate companies for periods included in comparative financial statements should be disclosed.

### **Subsequent Events**

**17.115** A pooling of interests consummated after the date of the current financial statements, but before the statements are issued, should be disclosed. Revenues, net earnings, earnings per share, if applicable, and the effects of the anticipated changes in accounting methods, as if the combination had been consummated on the date of the financial statements, should be included in the notes to the financial statements. A purchase acquisition of another company subsequent to the date of the financial statements, but prior to their issuance, should be disclosed in the notes to the financial statements. No specific details, however, are required in this disclosure.

**17.116** When, at the date of financial statements, a pooling has been initiated but not consummated, and the company is reasonably sure the combination will meet the requirements for the pooling-of-interests method of accounting, it should be recorded as an investment in stock of the other company as if acquired before the balance-sheet date. Until the pooling-of-interests method is finalized, the investment and net earnings of the acquiring company should include its share of earnings and losses of the other company after the acquisition date of the stock. The notes to the acquiring company's financial statements also should disclose the results of operations for the current and prior periods, presented as if the combination will later be accounted for under the pooling-of-interests method. The acquiring company's financial statements should be restated to include the combining company after the combination is completed.

### **Contingent Consideration**

**17.117** Contingent consideration for the purchase of another business should not be recorded as a liability. The notes to the financial statements, however, should contain disclosure of any contingency, commitments, or options specified in a purchase agreement. Any common stock equivalents, however, should be reflected in the computation of earnings per share, if applicable.

**17.118** Preacquisition contingent assets or liabilities of purchased companies should be recorded at estimated amounts if such estimates are feasible, and if it appears probable that the contingent asset or liability existed as of the end of the purchase price allocation period. Any subsequent adjustments of contingent assets or liabilities should be included in net earnings of the period in which the adjustment is determined.

### Disclosure Illustrations

**17.119** The following are illustrations of disclosure of a pooling-of-interests and a purchase.

#### Pooling-of-Interests Note

On June 7, 19X, the Company acquired all of the outstanding shares of common stock of FGH Company in exchange for XXX shares of the Company's common stock. The acquisition was accounted for as a pooling of interests. The 19W financial statements have been restated to include the accounts of FGH Company as of the beginning of the year.

Net sales and net earnings of the separate companies for the period ended September 30, 19X, the interim period nearest the date of acquisition, and for the year ended December 31, 19W are:

	September 30 <u>19X</u>	December 31 <u>19W</u>
Net sales:		
XYZ Company, Inc.	\$xxxx	\$xxxx
FGH Company	<u>xxx</u>	<u>xxx</u>
Combined	<u>\$xxxx</u>	<u>\$xxxx</u>
Net earnings:		
XYZ Company, Inc.	\$xxxx	\$xxxx
FGH Company	<u>xxx</u>	<u>xxx</u>
Combined	<u>\$xxxx</u>	<u>\$xxxx</u>

#### Purchase Note

On June 7, 19X, the Company acquired all of the outstanding shares of common stock of IJK Company. The Company paid \$xxxxx in cash and xxx shares of its common stock valued at \$xxxx. This acquisition has been accounted for as a purchase. The results of operations of IJK Company have been included in the consolidated accounts since the date of acquisition. The excess of cost over the net assets of IJK Company was \$xxxx and is being amortized over 40 years.

**17.200 RELATED-PARTY TRANSACTIONS**

**17.201** Related parties are defined as follows:

- Affiliates.
- Principal owners.
- Management and members of their immediate families.
- Entities for which investments are accounted for by the equity method.
- Any other party with which the reporting entity deals when one party has the ability to significantly influence the management or operating policies of the other, to the extent that one of the parties might be prevented from fully pursuing its own separate interests.
- Another entity that has the ability to significantly influence the management or operating policies of transacting parties.
- Another entity that has ownership interest in one of the transacting parties and has the ability to significantly influence the other, to the extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

**17.202** Established accounting principles do not require transactions with related parties to be accounted for differently from transactions conducted on an arm's-length basis. Related-party transactions should be considered within the framework of existing pronouncements with primary consideration being given to the adequacy of disclosures, noting such transactions and evaluating their significance in the financial statements of the reporting entity. Transactions such as interest-free or bargain-rate borrowings, real estate sales for amounts less than appraised values, nonmonetary property exchanges, and loans with no fixed maturity dates are examples of transactions that may be indicative of the existence of related-party interests.

**17.203** Disclosures in the financial statements should include the following:

- The nature of the relationship. Examples include equity interests, the nature and amount of voting or other control, and affiliated or controlling interests.
- A summary of the transactions, including amounts and any other information necessary to understand the effects of the transactions on the financial statements. Terms of the transactions, the basis of computing amounts exchanged, and the basis for allocating revenues and expenses shared with the related party are examples of such disclosures.
- The total dollar volume of the transactions and any changes in the methods of establishing terms from the preceding period.
- Amounts due to or from related parties, the terms and method of settlement. Receivables should be shown net of the allowances for uncollectibles, and descriptions of collateral for borrowing should be included in the notes to the financial statements.

**17.204** Transactions between or among related parties should be disclosed even though they are not given accounting recognition. An example would be receiving or providing services without charge.



**17.205** Any management representation included in the financial statements or related notes must be supported by corroborating evidence. The amount of corroborating evidence and the method of its collection will depend upon the type of engagement, i.e., audit, review, or compilation. Should management represent in the financial statements that a related-party transaction was consummated on an arm's-length basis, the accountant should evaluate the evidence collected to support that representation. If the accountant is unable to satisfactorily corroborate that representation, the standard report for the engagement may have to be modified.

**17.206 Disclosure of Major Customers or Suppliers.** An entity may be economically dependent on other parties with which it does a significant volume of business. Its business volume may be concentrated with a particular customer or supplier, and a partial or total loss of the business relationship could have an adverse effect on the business. Paragraphs 21 and 22(a) of Statement of Position (SOP) 94-6, *Disclosure of Significant Risks and Uncertainties*, require disclosure of such concentration if (1) the concentration exists at the financial statement date, and (2) the concentration makes the entity vulnerable to the risk of a near-term severe impact. Severe impact is defined as an event that has "a significant financially disruptive effect on the normal functioning of the entity." Severe impact is a higher threshold than material. (SOP 94-6 is discussed in Chapter 5.)

**17.207** Economic influence may also occur when one party has the ability to increase or decrease the volume of business done by two more entities in the same line of business. Disclosure of such influence should be made in the financial statements of the entity subject to such influence.

## **17.300 ACCOUNTING CHANGES**

### **Types of Accounting Changes**

**17.301** Accounting changes include a change in an accounting principle, in the reporting entity, or in an accounting estimate. The correction of an error in a previously-issued financial statement, such as a change from an unacceptable principle to an acceptable one, is not considered an accounting change. With few exceptions, the cumulative effects of changes in accounting principles are ordinarily included in net earnings of the period in which the change occurred. A few specified changes in accounting principles, and changes in the reporting entity, require restatement of the financial statements for all periods presented. The effects of a change in an accounting estimate are reported in the current and future periods affected by the change.

**17.302 Changes in Accounting Principles.** Changes in accounting principles or practices, and methods of applying them, require recognition in the accountant's or auditor's report. Examples of such changes include a change from the straight-line method to the declining-balance method of depreciation and a change from the LIFO method to the FIFO method of costing inventory.

**17.303** A change to an alternative acceptable accounting principle must be justified on the basis that it is preferable. Preference judgments made by the entity proposing the change should be based upon improvements in financial reporting. Income tax benefits alone do not establish preference. Changes to conform with AICPA Statements of Position and Industry Audit and Accounting Guides are changes to preferable accounting principles. The nature of, and justification for, a change in an accounting principle and its cumulative effect on earnings should be disclosed in the financial statements of the period in which

the change is made. Such disclosure should be repeated each time in the financial statements for the period in which the cumulative effect of the change is presented.

**17.304** The following list of items are *not* considered changes in accounting principles:

- A change from an unacceptable principle to one that is generally accepted. Such a change should be treated as correction of an error.
- Changes in methods of depreciation and amortization at specified points in the lives of assets when the original methods are supported by consistent historic application, e.g., change from accelerated to straight-line depreciation method. These changes are applied prospectively.
- Correction of errors in the application of an accounting principle.
- Initial adoption or modification of accounting principles for events or transactions occurring for the first time.

**17.305** For all changes in accounting principles, except those requiring restatement, note the following:

- Financial statements for prior periods should be presented as previously reported.
- The cumulative effect of changing to a new accounting principle on retained earnings at the beginning of the period in which the change is made should be included in net earnings of the period of change.
- The effects of adopting the new accounting principle on earnings before extraordinary items, on net earnings, and on the related per share amounts, if applicable, in the period of change, should be disclosed.
- Earnings before extraordinary items and net earnings computed on a pro forma basis should be shown in a note to the financial statements for all periods presented as if the newly adopted accounting principle had been applied during all periods affected.

**Earnings Statement Presentation — Change in Accounting Principle**

Earnings before cumulative effect of change	\$ xxxx
Cumulative effect of change in accounting principle, net of deferred taxes (Note X)	( <u>xxxx</u> )
<b>NET EARNINGS</b>	<b><u>\$ xxxx</u></b>

### Note Presentation — Change in Accounting Principle

As of January 1, 19X, the Company changed from the straight-line to the accelerated method of computing depreciation on substantially all of its property and equipment for financial statement purposes. Because of higher utilization and productivity early in the assets' lives, management believes the change will result in a better matching of costs and revenues.

The cumulative effect of the depreciation change on prior years, after reduction for deferred taxes of \$xxxx, has been charged to earnings for the year ended December 31, 19X, resulting in a reduction in net earnings of \$xxxx.

**17.306 Restatements of Prior Periods.** New authoritative accounting pronouncements often require restatement of prior periods affected by the new accounting principle. The disclosure requirements discussed below should be followed in disclosing these new principles unless they are specifically prohibited by new pronouncements.

**17.307** The specific changes in accounting principles that are required to be reported as a restatement of prior periods' financial statements are:

- A change from the LIFO method of inventory pricing to another method.
- A change in the method of accounting for long-term construction contracts.
- A change to or from full-cost method of accounting in extractive industries.
- A change from retirement-replacement-betterment accounting to depreciation accounting.

**17.308** Other special situations allowing optional retroactive restatement are:

- Changes in accounting principles made by a company that is issuing its financial statements to obtain additional equity capital from investors, effect a business combination, or register its securities. This exemption is available only for the first time the company's financial statements are used for any of these purposes.
- Changes in accounting principles made at the time of a pooling of interests to conform with the members of a group.

**17.309** The pro forma effects of retroactive application of changes should be shown on the face of the earnings statement for earnings before extraordinary items and net earnings. Earnings per share amounts should also be shown if required.

**17.310 Changes in Reporting Entities.** Changes in reporting entities such as presenting consolidated or combined statements in lieu of individual companies, changes of subsidiaries included in consolidated financial statements, or changing the companies included in combined financial statements affect the consistency standard of reporting and require recognition in the accountant's or auditor's report.

### Note Presentation — Change in Reporting Entities

As of January 1, 19X, the Company has consolidated the accounts of its wholly-owned subsidiary, FGH Company, to comply with SFAS No. 94, *Consolidation of All Majority-Owned Subsidiaries*. The accompanying financial statements for the year ended December 31, 19W, have been restated to reflect the consolidation.

**17.311 Changes in Accounting Estimates.** Changes in accounting estimates such as service lives and salvage values of depreciable assets, provision for warranty costs, uncollectible receivables, and inventory obsolescence require no mention in the auditor's (accountant's) report, although, if material, they do require disclosure in notes to the financial statements. The disclosure should include a description and the effects on pre-tax earnings in the period of the change.

### Note Presentation — Change In Accounting Estimate

As of January 1, 19X, the Company reduced the annual depreciation rate of certain equipment from 10% to 5% to better approximate the economic lives of the equipment. The effect of this change in estimate was to increase earnings before the provision for income taxes by \$xxxx for the year ended December 31, 19X.

### Correction of an Error in Previously-Issued Financial Statements

**17.312** Errors in previously-issued financial statements include mathematical mistakes, omissions, or duplication of data affecting financial statements, mistakes in the application of accounting principles, and the use of unacceptable principles. Correction of errors should result in the restatement of prior periods' statements and note disclosure of the effects of the change. The notes to the financial statements for the period in which a change is made should disclose the nature of, and justification for, the change and include the following disclosures for each period presented:

- Restatement effect on earnings before extraordinary items.
- Restatement effect on net earnings.
- Restatement effect on related per share amounts, if applicable.

**17.313** These disclosures are not required to be repeated in subsequent periods' comparative financial statements.

### Note Presentation — Restatement of a Prior Period

As of January 1, 19X, the Company changed its method of accounting for manufacturing overhead to conform with generally accepted accounting principles. Manufacturing overhead, previously expensed as incurred, is now being allocated to inventory production. The accompanying financial statements for the year ended December 31, 19W, have been restated to reflect the retroactive application of this change. The method of accounting was also changed for income tax purposes. A retained earnings increase of \$xxxx resulted as of December 31, 19V. The change in accounting for manufacturing overhead increased 19X net earnings by \$xxxx and

previously reported 19W income taxes and net earnings by \$xxx and \$xxxx, respectively.

When single-period statements are presented, the restatement should be shown as an adjustment of the opening balance of retained earnings.

### **Historical Summaries of Financial Information**

**17.314** When summaries of financial information are included with the basic financial statements for periods that contain changes in accounting principles requiring prospective or retroactive application, the historical summary of financial information should be prepared in the same manner and contain the same disclosures as the basic financial statements.

### **17.400 SUBSEQUENT EVENTS**

**17.401** Material events or transactions occurring subsequent to the balance-sheet date, but before the issuance of financial statements, require either adjustment or disclosure in the financial statements or notes.

**17.402** Additional evidence or new information concerning conditions that exist at the balance-sheet date, and that affect accounting estimates, should be reflected in the financial statements. Common subsequent events affect the realization of assets such as receivables or inventories, or the settlement of estimated liabilities accrued at year end. These types of subsequent events ordinarily require adjustment in the financial statements.

**17.403** Evidence concerning conditions that did not exist at the balance-sheet date, and that do not affect accounting estimates, should be disclosed in the notes if it is necessary for a fair presentation of the financial statements. Examples of subsequent events that would ordinarily be disclosed are:

- Significant interim losses occurring after the balance-sheet date.
- Substantial fixed asset acquisitions, commitments, or significant new or extended lease agreements.
- Significant increases in long-term borrowings and the pledging of additional collateral.
- The settlement or initiation of significant litigation that was initiated after the balance-sheet date.
- Significant transactions affecting the stockholders' equity in the business.

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**17.500 ASSETS AND LIABILITIES DISCLOSURES — GENERAL****Current Assets**

**17.501** Current assets consist of assets that are expected to be realized in cash, sold, or consumed in operations within the normal operating cycle of the business, which is usually one year. The total of current assets should be identified on the balance sheet.

**Contra Accounts**

**17.502** Contra accounts should be deducted from the assets to which they apply. The net asset account balance should ordinarily be presented on the balance sheet with explanation of the nature and amount of contra accounts included in the notes to the financial statements or on the face of the statement.

**Cash and Cash Equivalents**

**17.503** Cash on hand or deposit should be combined with cash equivalents and presented as a single amount, "Cash and cash equivalents." Cash equivalents are short-term, highly liquid investments that are both readily convertible to known amounts of cash and so near their maturity that they present insignificant risk of changes in value because of changes in interest rates. Interest-bearing time deposits or certificates of deposit should be included if they can easily be converted to cash. Generally, only investments with original maturities of three months or less will qualify. Items that are not considered the equivalent of cash, e.g., commercial paper, should be included in the marketable securities or investments classification.

**17.504 Restricted Cash.** Cash subject to withdrawal or usage restrictions should be shown as a separate line item or described in the notes to financial statements. Funds intended for use in increasing noncurrent assets or that are restricted for the liquidation of long-term debt should be classified separately or disclosed in the notes to the financial statements. Restricted cash should be classified as a current or noncurrent asset according to the nature of the asset or liability for which it is restricted. For example, cash restricted either for the purchase of noncurrent assets or the retirement of long-term debt should be classified as noncurrent.

**17.505 Overdrafts.** Bank overdrafts should be presented as current liabilities; however, the overdraft may be offset against other unrestricted bank balances if there is the right of offset. Bank overdrafts caused by checks written and not mailed at year end should be reclassified and presented as accounts payable.

**17.506 Compensating Balances.** Publicly held companies are required to separately classify and/or disclose minimum or compensating cash balances. If amounts of minimum or compensating balances are material, such disclosure may also be meaningful for the users of financial statements of nonpublic companies. The terms of the requirements, the amounts and any failure to comply should be disclosed in the related long-term debt note.

**Practice Tip:**

Checks that have been issued and have not cleared the bank but are out of the control of the reporting entity, should not be included in the balance sheet "cash" caption. A check is out of the payor's control after it has been mailed or delivered to the payee.

**17.507** The following is an illustration of the balance-sheet presentation of the situations described above.

**Balance-Sheet Presentation — Cash and Cash Equivalents**

<b>CURRENT ASSETS:</b>	
Cash and cash equivalents	\$xxxx
<b>OTHER ASSETS:</b>	
Time deposits restricted under long-term debt agreement (Note X)	\$xxxx
<b>CURRENT LIABILITIES:</b>	
Bank overdraft	\$xxxx
Notes payable	xxxx

**Investments in Debt and Equity Securities**

**17.508** SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, addresses the accounting and reporting for investments in marketable equity securities and for all investments in debt securities. SFAS No. 115 superseded SFAS No. 12, *Accounting for Certain Marketable Securities*.

**17.509** SFAS No. 115 requires investments in debt and marketable equity securities to be classified in three categories and accounted for as follows:

- Debt securities that the entity has the intent and ability to hold to maturity should be classified as *held-to-maturity securities* and reported at amortized cost.
- Debt and equity securities that are bought and held principally for the purpose of selling in the near term should be classified as *trading securities* and reported at fair value, with unrealized gains and losses included in earnings.
- Debt and equity securities not classified as either held-to-maturity securities or trading securities should be classified as *available-for-sale securities* and reported at fair value, with unrealized gains and losses excluded from earnings and reported in a separate component of shareholders' equity.

**17.510 Applicability.** SFAS No. 115 does not apply to not-for-profit organizations or to entities whose specialized accounting rules require them to account for all their investments at market value, such as defined benefit pension plans and investment companies.

**17.511 Disclosures.** For each balance sheet presented, the following should be disclosed separately for available-for-sale securities and for held-to-maturity securities:

- a. Aggregate fair value
- b. Gross unrealized holding gains
- c. Gross unrealized holding losses
- d. Amortized cost basis

Those disclosures should be made by major security type. For financial institutions, the following major security types should be included:

- a. Equity securities
- b. Debt securities issued by the U.S. Treasury and other U.S. government corporations and agencies
- c. Debt securities issued by state and political subdivisions thereof
- d. Debt securities issued by foreign governments
- e. Corporate debt securities
- f. Mortgage-backed securities
- g. Other debt securities.

For investments in debt securities classified as available-for-sale or held-to-maturity, separate disclosure should be made about their contractual maturities as of the date of the latest balance sheet presented.

**17.512** For each period for which an earnings statement is presented, the following disclosures should be made:

- a. The proceeds from sales of available-for-sale securities and the gross realized gains and losses from those sales.
- b. The basis on which cost was determined in computing realized gain or loss, i.e., specific identification, average cost, or other method used.
- c. The gross gains and losses included in earnings from transfers of securities from the available-for-sale category to the trading category.
- d. The change in net unrealized holding gain or loss on available-for-sale securities that has been included in the separate component of shareholders' equity during the period.
- e. The change in net unrealized holding gain or loss on trading securities that has been included in earnings during the period.



- f. For any sales of or transfers from held-to-maturity securities, the amortized cost amount of the sold or transferred security, the related realized or unrealized gain or loss, and the circumstances leading to the decision to sell or transfer the security.

### Offsetting Assets and Liabilities

**17.513** FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*, defines right of setoff and specifies what conditions must be met to have that right. It also addresses the applicability of that general principle to forward, interest rate swap, currency swap, option, and other conditional or exchange contracts, and clarifies the circumstances in which it is appropriate to offset amounts recognized for those contracts in the statement of financial position. In addition, it permits offsetting of fair value amounts recognized for multiple forward, swap, option, and other conditional or exchange contracts executed with the same counterparty under a master netting arrangement.

The Interpretation states a right of setoff exists when all of the following conditions are met:

1. Each of two parties owes the other determinable amounts.
2. The reporting party has the right to setoff the amount owed with the amount owed by the other party.
3. The reporting party intends to setoff.
4. The right of setoff is enforceable at law.

A debtor having a valid right of setoff may offset the related asset and liability and report the net amount.

### Financial Instruments

**17.514** In December 1991, the FASB issued SFAS No. 107, *Disclosures about Fair Value of Financial Instruments*. This Statement requires companies to disclose the fair value of all financial instruments, whether or not recognized in the balance sheet. It defines fair value as the amount at which the instrument could be exchanged in a current transaction between willing parties, other than a forced or liquidation sale. The quoted price for a single trading unit in the most active market is the basis for determining market price and reporting fair value. Therefore, quoted market price multiplied by the number of trading units equals the fair value to be disclosed.

**17.515** The Statement is effective for financial statements issued for fiscal years ending after December 15, 1992, or after December 15, 1995 for entities with less than \$150 million in total assets in the current balance sheet. The financial statements and notes checklist in Chapter 18, section 18.200 includes the required disclosures for this Statement.

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**Trade Notes and Accounts Receivable**

**17.516** Trade notes and accounts receivable should be presented separately from other receivables categories. If other receivables categories are material, they should, of course, be separately described. For material accounts and notes, disclosure of the nature of any related collateral may be meaningful. Debit balances in accounts payable for amounts due from vendors should be included as accounts receivable. Credit balances in accounts receivable for amounts due to customers should be presented as accounts payable.

**Receivables From Officers, Directors, Shareholders, Affiliated Entities, and Employees**

**17.517** Receivables from officers, directors, stockholders, affiliated companies and employees should be shown separately on the face of the balance sheet with disclosure of any necessary allowance for uncollectible accounts.

**Notes Receivable, Other Notes, and Accounts Receivable**

**17.518** Notes and accounts receivable arising from transactions outside the normal course of business should be presented separately on the balance sheet according to their nature, i.e., current or noncurrent. The disclosure of material notes receivable should include the effective interest rate, the total of the face amounts of notes, and any related allowance for uncollectible amounts.

**17.519 Installment Accounting Method.** In rare instances in which the collection of accounts receivable is not reasonably assured, the installment accounting method can be used. Such accounts should be classified according to their current and noncurrent portions. The notes to the financial statements should disclose the method of accounting and explain the reasons supporting its use. Unearned discounts, interest, or finance charges should be netted against the related receivable.

**17.520 Receivables Financing.** Receivables discounted, factored, or sold with or without recourse should be disclosed in the notes to the financial statements. Financial statement disclosures should include a description and the aggregate amount of notes sold during the period, any amounts that are retained by factors for uncollectible accounts, retained amounts included in earnings of the period, the unpaid balance of the notes, and the balance of the amounts retained by factors at the balance-sheet date. For receivables transferred with recourse reported as sales, the transferor's financial statements should disclose (a) the proceeds to the transferor for each period an income statement is presented, and (b) the balance of the receivables transferred that remain uncollected at the date of each balance sheet presented.

**17.521 Allowance for Uncollectible Accounts.** Allowances for uncollectible accounts are required by GAAP. Allowances for uncollectible accounts should be deducted from receivables and disclosed parenthetically on the balance sheet.

**17.522** The following illustrates the balance sheet presentation for the situations described above:

### Balance Sheet Presentation — Accounts and Notes Receivable

Accounts and notes receivable:		
Trade, less allowance for doubtful accounts of \$xxx and \$xxx	\$xxxx xxxx	
Affiliated companies (Note X)	xxxx	
Officers and directors		\$xxxx
Employees		xxxx
Other		xxxx

#### Inventories

**17.523** Inventories held for sale in the ordinary course of business, in the process of production, or available for use in the production of products or services should normally be classified as finished goods, work-in-process, or raw materials. Major inventory categories should be disclosed in the balance sheet or in a note to the financial statements.

**17.524** Note 1, Summary of Significant Accounting Policies, should disclose the costing method and the method of determining the overall carrying amount, e.g., lower of cost, first-in, first-out method, or market.

**17.525** Market is commonly defined as the current cost of replacement by purchase or reproduction. Market valuations may be applied to each individual item in inventory or to the aggregate of major categories of inventory. The method of determining market value should be used consistently. Market valuations should not exceed a ceiling of net realizable value, i.e., estimated selling price in the ordinary course of business less reasonably predictable costs of completion and disposal. The market valuation should not extend below a floor, which is net realizable value reduced by an allowance for a reasonable profit margin. Material write-downs, under the lower of cost or market rule, ordinarily will be presented separately from costs of sales in the earnings statement or may be disclosed in notes to the financial statements.

**17.526** Full absorption costing, i.e., allocating direct manufacturing expenses to inventories, is the acceptable method of accounting for inventories. Direct costing, i.e., treating manufacturing expenses as period costs, is not acceptable.

**17.527 LIFO Inventories.** The LIFO method of accounting for inventories may also be used for income tax purposes. Ordinarily the adoption of the LIFO method for tax purposes requires that it be used for financial accounting purposes. IRS procedures and rulings must be observed to avoid the inadvertent termination of the LIFO election for tax purposes. The accounting firm's tax partner should be consulted in connection with any clients reporting inventories on the LIFO method.

**17.528** Any write-down of LIFO inventories to market value will not be deductible for tax purposes. Such write-downs are permanent differences and any tax effect should be recognized currently.

**17.529** Income realized from the liquidation of LIFO inventory, carried at amounts lower than current costs, should be disclosed in the notes to the financial statements.

**Practice Tip:**

Inventory costs required to be capitalized under the Tax Reform Act of 1986 need not or may not necessarily be capitalized for financial statement purposes. Factors such as the nature of the entity's operations and industry practices should be considered in determining the inventory capitalization policy for financial reporting purposes. (See EITF Issue No. 86-46, *Uniform Capitalization Rules for Inventory Under the Tax Reform Act of 1986.*)

**Prepaid Expenses**

**17.530** Prepaid expenses represent payments that produce benefit in the next operating cycle. Prepaid expenses should be charged against revenues of the next cycle. Common prepaid expenses include prepaid insurance, taxes, and rentals. Such amounts will ordinarily be combined into a prepaid expenses category unless they are individually material or are necessary information for the users of the financial statements.

**Investments In and Advances To Affiliated Entities**

**17.531** A reporting entity's interest in affiliated companies of more than 50% should be presented by preparing consolidated financial statements.

**17.532** The equity method of accounting should be used for all unconsolidated subsidiaries 50%-or-less owned, and more than 20%-owned, over which the reporting entity is able to exercise "significant influence." Incorporated joint ventures should also be accounted for on the equity method. Other investments, generally, should be carried at cost. Changes to the equity method from another method of accounting, because of increase in ownership, should result in retroactive adjustments of the investment, current and prior periods' results of operations and retained earnings of the reporting entity. The changes should be described in a note to the financial statements. Any prior period financial statements presented should be restated.

**17.533** When a company changes from the equity method to another method of accounting because of ownership declining below 20%, or for other reasons, retroactive adjustment to the investment account should *not* be made. After such a decline, the cost method of accounting should be used. Any dividends received by the reporting entity in excess of its share of earnings should be treated as a recovery of the cost of the investment. A change from the equity method should be disclosed in the notes to the financial statements along with the effect in the current period of the change on net earnings, and earnings per share, if applicable.

**17.534 Presentation.** The investments in affiliated companies accounted for on the equity method should be disclosed in the notes to the financial statements according to major classes of investment, i.e., subsidiaries, affiliates, corporate joint ventures, or other companies owned 50% or less. Advances to companies owned 50% or less should be disclosed separately in the notes or on the face of the balance sheet. The investor's share of earnings or losses under the equity method should be presented in the earnings statement as a separate line item. The investor's share of any extraordinary items or prior-period adjustments should be presented according to the nature of the items.

**17.535 Fiscal Years.** The investor should record earnings from affiliated companies based on the most recent available financial statements of such companies. Any differences in fiscal years should be consistent from period to period, and any subsequent events occurring from the date of an investee's financial statements, and the report on the investor's financial statements, should be disclosed or adjusted depending upon the materiality and the nature of the event.

**17.536 Losses on Investments.** Provisions for losses or uncertain realization of investments should be disclosed in the notes to the financial statements. Ordinarily, losses should not be provided in excess of the carrying amount of the investment and any advances accounted for under the equity method. Any commitments for financial support beyond such carrying amounts and advances should be disclosed.

**17.537 Dividends.** Dividends received under the equity method should reduce the carrying amount of the investment. Dividends received under the cost method should be reported as earnings to the extent of the investor's share in such earnings subsequent to the date of acquisition. Earnings preceding the date of acquisition, which are included in dividends, should be treated as cost recoveries.

**17.538 Other Disclosures.** The notes to the financial statements should disclose the names and percentage ownership of affiliated companies, along with the method of accounting applied to each. Differences between the carrying amount of an investment and the investor's share of equity in the net assets of the investee should also be disclosed.

**17.539** A summary of assets, liabilities, and results of operations should be included in the notes to the financial statements when the investment in affiliated companies in the aggregate has a significant impact on the reporting entity's financial position or results of operations.

**17.540** When taxes are not accrued on undistributed earnings of an equity investee company, the notes to financial statements should include a declaration of the affiliated company's intent to reinvest the earnings or distribute the earnings in a tax-free liquidation. The cumulative amount of undistributed earnings for which taxes have not been provided should be disclosed.

**17.541** Income taxes on undistributed earnings from investments accounted for on the cost method should be provided in the financial statements.

### **Property and Equipment**

**17.542** Property and equipment should include productive assets that are used to generate the company's revenues. The cost of major classes of assets and related accumulated depreciation should be disclosed in a note to the financial statements. The accumulated depreciation can be deducted from each major class of assets or in total from all depreciable assets.

**17.543** Current charges for depreciation, depletion or amortization should be disclosed in the statement of earnings, statement of cash flows, or in the notes to the financial statements. Depreciation methods and rates should be disclosed in Note 1 to the financial statements (*Summary of Significant Accounting Policies*). Changes in policies, or other significant circumstances, should also be disclosed in the notes.

**17.544** Other material amounts that should be presented separately in the balance sheet or disclosed in a note to the financial statements, include fully depreciated assets still in use, idle plant or equipment held for sale, construction in progress, and unusual commitments for fixed assets acquisition.

**Practice Tip:**

As discussed in Chapter 5, in March 1995 the FASB issued SFAS No. 121, *Accounting for the Impairment of Long-Lived Assets to Be Disposed Of*. The Statement establishes accounting standards (including measurement and disclosure requirements) for the impairment of long-lived assets, certain identifiable intangibles, and goodwill related to those assets to be held and used and for long-lived assets and certain identifiable intangibles to be disposed of. The statement is effective for financial statements for fiscal years beginning after December 15, 1995, with earlier application encouraged. Restatement of previously issued financial statements is prohibited.

**Leases — Lessees**

**17.545** SFAS No. 13, *Accounting for Leases*, as amended and interpreted (AC L10), offers guidance in determining lease classifications. Leases in the financial statements of lessees are recorded either as operating leases or capital leases.

**17.546** General disclosures for leasing arrangements under both capital and operating leases should include, at least, the following:

- A description of the leased property and its accounting classification
- Terms and expiration dates of the lease
- Method of determining any contingent rental payments
- Descriptions of any renewal or purchase options or escalation clauses
- Descriptions of any significant restrictive covenants imposed by the lease agreement

**17.547 Operating Leases.** Leases in the financial statements of lessees that do not meet the criteria for capital leases are recorded as operating leases. Operating-lease rental payments are charged to earnings in the period to which they apply.

**17.548** The notes to financial statements should contain the following disclosures for operating leases with initial or remaining noncancelable terms in excess of one year:

- Future minimum rental payments, in the aggregate and for each of the five succeeding fiscal years
- The total of minimum rentals to be received in the future under noncancelable subleases

**17.549** Rental expense should be disclosed for each period for which an earnings statement is presented. Such disclosures should include separate amounts for minimum rentals, contingent rentals, and sublease rentals.

**17.550 Capital Leases.** Assets and liabilities resulting from capitalized leases should be recorded at the present value of minimum lease payments, net of any executory costs. Capitalized leased assets, and the related capitalized lease obligations, should be presented as separate line items in the balance sheet. Any current portion of the capitalized lease obligation should be classified as a current liability.

**17.551** Note disclosures should include the following:

- The gross amount of capitalized leased assets, by major classes, along with the related accumulated amortization.
- Future minimum lease payments, in total, and for each of the five succeeding fiscal years, less deductions for amounts of executory costs and present value interest included in the minimum lease payments as of the date of the last balance sheet presented.
- The total of minimum sublease rentals to be received under noncancelable subleases as of the date of the last balance sheet.
- Total contingent rental expenses incurred for each period in which an earnings statement is presented, amortization expenses, unless included with depreciation expense for fixed assets, and the company's amortization methods for leased assets.

**17.552** The Financial Statements and Notes Checklist in Chapter 18, section 18.200 contain a more extensive (although not all-inclusive) list of disclosures.

#### **Leases — Lessors**

**17.553** Capital leases in the financial statements of a lessor can be classified as follows:

- Sales-type leases
- Direct financing leases
- Leveraged leases
- Operating leases

**17.554 Sales-Type and Direct Financing Leases.** The net investment in sales-type and direct financing leases should be presented as a separate line item in the balance sheet. The current portion of the assets should be presented separately in current assets. The amount of the net investment, ordinarily minimum lease payments receivable plus unguaranteed residuals, less unearned income, should be included in the notes to the financial statements. Unearned income should be amortized over the lease term by the simple interest method. Any contingent rentals should be included in earnings when they are due. Other leases that do not meet the criteria for capitalization are operating leases. Property subject to operating leases should be presented as separate line items in the balance sheet under the property and equipment or investments classifications depending on the nature of the lessor's business. For example, a lessor that is not in the leasing business would normally classify property subject to operating leases as an investment. Rent received under operating leases should be included in earnings in the years for which it is due.

## General Disclosures Under Leasing Arrangements

**17.555** The nature of the leased property and the classification of the leases, the lease periods and the methods of computing contingent rentals should be described in the notes to the financial statements. If a significant part of a lessor's revenue, net earnings, or assets are related to sales-type, direct financing or operating leasing activities, exclusive of leveraged leasing, the following disclosures should be included in the notes to the financial statements for each balance sheet presented.

**17.556 Sales-Type and Direct Financing Leases.** Disclosure requirements include:

- The components of the lessor's net investment, i.e., minimum lease payments and unguaranteed residuals, less executory costs and related profit, unearned income, and allowances for uncollectibles.
- The total of minimum lease payments less any executory costs and related profit, or any allowance for uncollectible minimum lease payments.
- Any unguaranteed residual value.
- Minimum lease payments for each of the five fiscal years succeeding the date of the latest balance sheet presented.
- The total contingent rentals on direct financing leases that are included in earnings and any amounts of unearned income which are offset against initial direct costs that have been charged against earnings.

**17.557 Operating Leases.** The notes to the financial statements should disclose the cost of leased property by major classes and the total amount of accumulated depreciation at the date of the latest balance sheet presented. Minimum future rentals on noncancelable leases should be included in the aggregate and for each of the five fiscal years succeeding the date of the latest balance sheet presented. Any contingent rentals included in earnings should be disclosed for each period in which an earnings statement is presented.

**17.558 Leveraged Leases.** Leveraged leases are direct financing leases that involve a third-party creditor with nonrecourse debt financing that provides leverage for the lessor. The lessor's net investment is lower in early years and increases in the later years of the lease.

**17.559** The lessor's net investment will include rents receivable in excess of the amount of debt service, the estimated residual value of the asset, and pretax unearned income.

**17.560** The earnings statement should disclose the pretax earnings from the leveraged lease. The income taxes on such earnings included in earnings of the period should be included with the customary disclosures of the components of the provision for income taxes.

**17.561** When a significant part of the revenues, net earnings, or assets of the lessor are derived from leveraged leases, the notes to the financial statements should disclose the components of the net investment and any related deferred taxes resulting from a leveraged lease. The terms of the lease, the nature of the leased property and its estimated life, any estimated residual value of the leased property at the end of the



lease, the nature of the third-party financing, and any other related tax matters should be disclosed in the notes to the financial statements.

**17.562** The following is an illustrative balance-sheet presentation of assets recorded under capital leases and sample note disclosures for both capital and operating leases.

#### Lessor's Assets Recorded Under Capital Leases — Balance-Sheet Presentation

<b>CURRENT ASSETS:</b>	
Cash	\$XXXX
Notes and accounts receivable	XXXX
Current portion of net investment in direct-financing, sales-type, and leveraged leases	XXXX
Inventories	XXXX
Prepaid expenses	<u>XXXX</u>
<b>TOTAL CURRENT ASSETS</b>	<b>\$XXXX</b>
Net investment in direct-financing, sales-type, and leveraged leases (Note X)	<b>\$XXXX</b>

#### Lessor's Capital Leases — Note Presentation

The Company is a lessor of fleet vehicles under agreements expiring at various dates through 19ZD. The majority of the capital leases are direct-financing and sales-type leases. Certain leases were leveraged through third-party nonrecourse financing secured by a first lien on the fleet vehicles. The fleets will be returned to the Company after expiration of the lease term. Deferred taxes arise from accounting for leveraged leases as operating leases for income tax purposes. There are no contingent rentals for any of the leases. The Company's net investment in direct-financing, sales-type, and leveraged leases is as follows:

Total minimum lease payments	\$XXXX
Estimated executory costs and related profit	( <u>XXX</u> )
Minimum lease payments receivable	XXXX
Estimated unguaranteed residual values	XXXX
Allowance for uncollectibles	( XXX )
Unearned interest	( XXX )
Deferred taxes from leveraged leases*	( XXX )
Principal and interest on nonrecourse debt from leveraged leases	( <u>XXX</u> )
Net investment in direct-financing, sales-type and leveraged leases	<u><b>\$XXXX</b></u>

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\* Amounts are included only for determining the net investment in leveraged leases.

Future minimum lease payments receivable under the capital lease agreements are:

19Y	\$xxxx
19Z	xxxx
19ZA	xxxx
19ZB	xxxx
19ZC	xxxx
19ZD and thereafter	<u>xxxx</u>
 Total minimum lease payments receivable	 <u>\$xxxx</u>

**Lessor's Operating Leases — Note Presentation**

The Company leases single vehicles under noncancelable leases for various terms of two to seven years which are accounted for as operating leases. Future rentals from such leases as of December 31, 19X are:

19Y	\$xxxx
19Z	xxxx
19ZA	xxxx
19ZB	xxxx
19ZC	xxxx
19ZD and thereafter	<u>xxxx</u>
 Total minimum future rentals	 <u>\$xxxx</u>

**Capitalized Interest**

**17.563** Interest costs from direct or indirect outstanding borrowings to acquire or construct qualifying assets should be capitalized for the period during which the asset is being prepared for use. Qualifying assets include assets constructed or produced for a company's own use, and assets intended for sale or lease that are constructed or produced as separate discrete projects.

**17.564** The following are *not* considered qualifying assets. Related interest costs should not, therefore, be capitalized. These assets are:

- Large quantities of routinely manufactured or produced inventories.
- Assets not undergoing preparation for use, or assets that are not being used, in the business of the company.
- Assets currently being used, or that are ready for use, in the business of the company.

**17.565** Essentially three circumstances are necessary for assets to qualify for interest capitalization. They are:

1. Interest cost on borrowings is being incurred either directly or indirectly for the benefit of the qualifying asset.
2. There is some activity taking place that will ready the asset for use in the operations of the business.
3. Expenditures are being incurred in respect of the qualifying asset.

**17.566** The notes to the financial statements should include disclosure of the current period's interest expense that is not capitalizable, the full amount of interest incurred during the period, and the portion of total interest expense during the period that has been capitalized.

#### **Capitalized Interest — Note Presentation**

The Company capitalizes interest costs on property and equipment constructed for use in its business. Total interest costs were \$xxx and \$xxx for the years ended December 31, 19X and 19W respectively. Of these amounts, \$xxx and \$xxx were capitalized in 19X and 19W. The remaining interest expense has been charged to operations.

#### **Intangible Assets**

**17.567** This classification may include, among other items, the following:

- Differences between a parent's cost and its equity in the net assets of a purchased, consolidated subsidiary that is not allocable to specific assets, i.e., goodwill
- Unamortized issue costs on bonds or other debt
- Start-up or preoperating costs

#### **Other Assets**

**17.568** The amount of any amortization, its method and period of amortization for goodwill or other deferred or intangible assets should be disclosed in the notes to the financial statements, if material. The amount of accumulated amortization and any reasons for not amortizing intangible assets should also be included. Contingent assets should not be recognized in the financial statements until realization is reasonably assured. Any contingent assets ordinarily should be disclosed in a note to the financial statements. Examples of contingent assets include claims in litigation and income tax carryovers for operating losses.

**17.569** Intangible assets and deferred charges should be segregated between their current and noncurrent portion in the balance sheet.

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**17.570** Other investments, deposits, and the cash surrender value of officers' life insurance should be presented under the classification "Other Assets."

### **Current Liabilities**

**17.571** Liabilities that are due within one year, require the use of current assets for their satisfaction, or that are directly related to other current assets or current liabilities should be classified as current liabilities in the balance sheet. The total of current liabilities should be identified on the balance sheet. The classifications of current liabilities are normally presented in an order that reflects both their materiality and prioritization of claims on current assets. The Illustrative Financial Statements in Chapter 18, section 18.500 present current liabilities classifications in a commonly used order.

**17.572 Notes Payable.** Notes payable are usually the first caption of the current liabilities. It normally represents current short-term borrowings from banks. Unless such notes are unusually large, or other special circumstances exist, disclosures will ordinarily consist of only interest rates and type of lender. In special circumstances, such as a company suffering cash flow problems, or where material amounts of short-term notes are due shortly after the report date, the payment terms and nature of the collateral may also be disclosed.

**17.573** Short-term notes payable should be classified according to type of lender: bank, finance company, trade creditors or officers, directors, stockholders, and employees.

**17.574 Accounts Payable.** Accounts payable should represent amounts due suppliers in the normal course of business. Advances from customers, amounts owed to directors, officers, stockholders, employees, and affiliates should be classified separately.

**17.575 Accrued Expenses.** Accrued expenses normally consist of salaries and wages, payroll, and other taxes and interest. Other expense classifications may, however, be classified separately if such classification is more meaningful for the user of the financial statements.

**17.576 Compensated Absences.** Costs of vacations, illnesses, and holidays for which employees will be paid should be accrued if all of the following conditions are met:

- The employer's obligation relating to employees' rights to receive compensation for future absences is attributable to employees' services already rendered.
- The obligation relates to rights that vest or accumulate.
- Payment of the compensation is probable.
- The amount can be reasonably estimated.

**17.577** If all conditions other than the last one are met, the reasons for not making an accrual should be disclosed in a note.

**17.578 Income Taxes.** The following items should be followed for classifying deferred taxes under SFAS No. 109, *Accounting for Income Taxes* (AC I27):

- If a company presents a classified balance sheet, deferred tax assets and liabilities must be shown according to the classification of the related asset or liability; or if there is no related asset or liability, according to the expected reversal or utilization date.
- There must be separate classifications for each tax paying component, i.e., if there are two subsidiaries.
- The asset and liability can be offset for each component under each separate classification (current/noncurrent) but different components cannot be offset.
- The following components of the net deferred asset or liability must be disclosed:
  1. Total deferred tax liabilities,
  2. Total deferred tax assets,
  3. Total valuation allowance,
  4. Net change in the valuation allowance for the year, and
  5. Types of temporary differences and carryforwards that cause the significant deferred assets and liabilities.
- If there is a valuation allowance, it should be prorated between current and noncurrent, according to the relative size of the gross deferred tax asset in each classification.

**17.579 Dividends Payable.** Cash dividends declared at the balance-sheet date should be classified separately as current liabilities. Stock dividends declared and payable at year end should be recorded when declared by charging retained earnings with the estimated fair value of the stock dividend. As a matter of practice, large dividends are recorded at par value. Par or stated value should be credited to the appropriate capital stock classification and any excess fair value credited to additional paid-in capital.

**17.580 Estimated Liabilities.** Liabilities such as service warranties for products, repairs and maintenance, and workmen's compensation claims may represent current liabilities for which the amount and date payable are not exactly known. If the payment obligation is probable, estimates of the amounts due, based on company or industry experience or on special studies or estimates by company personnel, should be used to record the obligation. These liabilities should be described as estimated and classified as current or noncurrent according to their nature.

**17.581 Life Insurance Policy Loans.** Current loans against life insurance policies should be classified as a current liability only if the company intends to repay the loan within the next operating cycle. If the company plans to repay the loan by deduction from a future distribution of the proceeds or cash surrender value of the policy, the loan should be offset against the cash surrender value of the policy. Ordinarily, cash surrender value of life insurance or related policy loans will not be classified as current.

**Long-Term Liabilities**

**17.582 Long-Term Debt.** The required disclosures for long-term debt include the following:

- Amounts of debt classified by type of borrowing, e.g., finance company, banks, or other sources. Notes with similar interest computation methods, i.e., installment notes, simple interest notes, or floating interest rate notes, can be summarized and classified together.
- Interest rates.
- Due dates and method of payment of installments.
- Nature of collateral pledged.
- Details of any subordination.
- Description of any conversion features.
- Any restrictive covenants such as minimum or compensating cash balance requirements, maintenance of working capital requirements, limits on additional investments, expenditures or leases of equipment, or dividend restrictions.
- Unremedied defaults or breach of covenants. Such situations may cause the long-term debt to be reclassified as current.
- Significant changes in long-term debt after the balance-sheet date until the date of the report, including any new restrictive covenants.
- Descriptions of material gains or losses on extinguishment of debt and their income tax effects.
- Amounts of interest paid on a cash basis, net of any amounts capitalized, for all years presented.

**17.583** Ordinarily, the names of lenders will not be included in the long-term debt disclosures. It may be appropriate, however, to describe by name any mortgage note or bond issues. All short-term notes payable, the current portion of long-term debt, and obligations callable by a creditor should be classified as current liabilities. The current portion of long-term debt, i.e., the amount maturing within one year, should be classified as a current liability. The current maturities of long-term debt should be presented for each of the five years following the date of the latest balance sheet.

**17.584 Unconditional Purchase Obligations.** An unconditional purchase obligation is one that is generally noncancelable, that has a remaining term of more than one year, and that was negotiated as part of arranging financing for (1) facilities that will provide contracted goods or services or (2) costs related to those goods or services.

**17.585** Disclosures of unrecorded unconditional purchase obligations should include:

1. The nature and terms of the obligations.
2. The aggregate amount of the fixed or determinable portion of the obligations at the latest balance-sheet date and, if determinable, for each of the five succeeding years.
3. The nature of any variable components of the obligation.

4. The amounts purchased under the obligations for each period an earnings statement is presented.

**17.586** Disclosures for recorded unconditional purchase obligations should include the aggregate amount of payments for each of the five years succeeding the latest balance sheet presented.

### Imputed Interest

**17.587** In the case of noninterest-bearing notes, notes with unreasonable interest rates, or notes substantially different from the cash sales price of the items purchased, interest should be imputed. An imputed discount or premium should be presented as a deduction from, or an addition to, the face amount of the notes. Noninterest-bearing notes exchanged for cash and recorded at the amount of cash given up, are recorded at their fair value and require no interest imputation.

### Contingencies

**17.588** A contingency is an uncertainty concerning a possible gain or loss affecting the company that will be resolved at some future date. Loss contingencies include potential catastrophic losses, discontinued operations, hazard losses, and product warranties. Gain contingencies include net operating loss carryovers. Gain contingencies should be disclosed in a note, but are not recognized in the financial statements until the contingency is removed.

**17.589** If the following conditions exist, contingent losses should be recorded:

- Based on information available prior to the issuance of the financial statements, it is probable that an asset has lost value or a liability has been incurred at the balance-sheet date.
- The loss is subject to reasonable estimation.

**17.590** If only one of the conditions exists, or if there is a reasonable, but remote, possibility that a loss contingency may occur, disclosure should be made in the notes to the financial statements. Examples of contingencies that ordinarily require disclosure are guarantees of debt of others, notes or accounts sold with recourse, lease guarantees, note endorsements, or contingent liabilities to subcontractors. A description of the contingency and an estimate of the future possible loss should be disclosed in a note to the financial statements. If amounts of the contingency cannot be estimated, the notes should so state.

### Gain Contingency Note Presentation — Income Tax Carryovers

At December 31, 19X, the Company had net operating losses available to offset future taxable income and tax liabilities which expire as follows:

<u>Expiration Year Ending</u>	<u>Net Operating Loss Carryovers</u>
19Y	\$xxxx
19Z	xxxx
19ZA	xxxx
19ZB	xxxx
19ZC	<u>xxxx</u>
	<u>\$xxxx</u>

**Loss Contingency — Note Presentation**

The Company is contingently liable for \$xxxx on customers' notes that have been assigned to banks with recourse. The Company is also contingently liable on guarantees of notes payable to banks by others of \$xxxx.

**17.591 Litigation.** Contingencies concerning litigation should either be recorded in the financial statements or disclosed in a note to the financial statements, depending on the likelihood of loss. The note to the financial statements should include management's and counsel's opinion concerning the outcome of the litigation.

**Litigation — Note Presentation**

In March, 19X, a civil action was filed against the Company alleging patent infringement concerning the Company's principal product. The suit asks for damages of \$xxxx. The Company is contesting this action and denying the allegations included therein. Management, after considering information furnished by counsel, believes the outcome of the suit will not materially affect the financial position of the Company.

**17.592 Commitments.** A commitment is an existing agreement to perform that is not dependent upon some future event or decision. Significant commitments for the acquisition or construction of property or equipment, material purchases of merchandise or inventory to be used in operations, leases and retirement plans existing at the balance-sheet date or arising prior to the report date, should be disclosed in a note to the financial statements. The caption "Commitments" and the corresponding note reference should be placed on the balance sheet. Dollar amounts should not be included on the face of the statement but should be disclosed in the accompanying note.

**Commitments — Note Presentation**

The Company has commitments to purchase significant amounts of raw materials over the next three years at the prevailing market prices. At December 31, 19X, these commitments are approximately \$xxxx based on current prices, and are not in excess of estimated production requirements.

**AUDIT ALERT****Environmental Matters**

A rapidly increasing problem for companies and their auditors is how to account for environmental contingencies and liabilities and the related audit consequences. The accounting literature requires a loss contingency to be accrued if (1) it is probable that a loss will occur and (2) the amount can reasonably be estimated. If either of these conditions is not met, disclosure is required unless the possibility of loss is remote. The AICPA Financial Report Survey, *Illustrations of Accounting for Environmental Costs*, published in July 1993 (Product No. 037996), provides sample disclosures.

Auditors should inquire of management whether the entity (or any of its subsidiaries) has a high-risk exposure to environmental liabilities. Such exposure could result in an accrual for cleanup costs or the disclosure of a contingency and the possible addition of an explanatory paragraph in the auditor's report.



**AUDIT ALERT****Environmental Matters (Continued)**

Auditors should be alert to potential "red flags" that indicate a possible exposure due to environmental issues. Examples of such red flags include:

- Participation in a real estate transaction or corporate merger involving properties with environmental risks (for example, chemical companies).
- The purchase of land at a price significantly below local market prices (a possible bargain sale due to environmental risk).
- The acquisition of new or increased insurance coverage against environmental risks or liabilities to third parties.

**Retirement and Pension Plans**

**17.593** For retirement or pension plans, the notes to the financial statements should include the following:

- A statement that such plans exist.
- The employees or employee groups covered.
- A description of the accounting and funding policies.
- The amount and components of costs for such plans charged to earnings for the current period.
- Disclosure of the nature of any accounting change for such things as actuarial cost methods, amortization of past and prior service cost and treatment of actuarial gains and losses should be made in a note to the financial statements for the period of change. Changes in actuarial assumptions and adoption or amendment of a plan should also be disclosed. Any such changes should be accounted for prospectively.
- For defined-benefit pension plans, additional disclosures include the actuarial present value of accumulated vested and non-vested benefits of covered employees, the assumed rate of return used in the computations, the total net assets available for benefits, the computation of any prepaid or accrued pension costs, and the date such information was determined.

**17.594** SFAS No. 87, *Employers' Accounting for Pensions* (AC P16), requires companies (1) to recognize compensation costs, based on the plan benefit formula, of an employee's pension benefits approximately over the service life of that employee, (2) to disclose components of net pension cost and the plan's funded status, and (3) to recognize a liability when the accumulated benefit obligation exceeds the fair value of plan assets.

**17.595 Profit-Sharing Plans.** A note to the financial statements should disclose the existence of a plan and the group of employees covered, the principal provisions of the plan, and the amount charged to earnings of the current period.

**AUDIT ALERT**

The current economic environment has caused some entities to restructure their business operations, which may also involve layoffs of employees and the curtailment or termination of pension plans and other benefits. Auditors should determine whether an entity has accounted properly for the effects of terminations and layoffs including disclosure of any material contingencies.

**17.596 Deferred Compensation Contracts.** Deferred compensation contracts that, in the aggregate, constitute a pension or retirement plan, should be disclosed in the notes to the financial statements. The disclosures required are the same as outlined above for retirement or pension plans.

**Stock Option and Stock Purchase Plans**

**17.597** The notes to the financial statements should disclose the following:

- A description of the plan and employees covered.
- As of the latest balance-sheet date, the number of shares under option or reserved, the option or purchase price, and the number of shares as to those options that are exercisable or that are reserved for subscriptions.
- As to the activity during the current period:
  - The number of shares and the option price of shares exercised under stock option plans.
  - The number and price of shares subscribed, purchased, and canceled under stock purchase plans.
- The method of measuring any compensation arising from employee stock option or purchase plans.

**Stock Option Plan — Note Presentation**

Under the Company's (qualified or nonqualified) Stock Option Plan, xxxx shares were reserved for issuance to key employees of the Company. Such shares will be issued upon the exercise of options at prices not less than 100% of fair market value at the time the option is granted.

Options that became exercisable and that were exercised during 19X follow:

	<u>Exercisable</u>	<u>Exercised</u>
Number of shares	xxxx	xxxx
Option price:		
Per share	\$xx.xx	\$xx.xx-xx.xx
Total	\$ xxxx	\$xxxx

Fair market value on dates options became exercisable or were exercised:

Per share	\$xx.xx	\$xx.xx-xx.xx
Total	\$ xxxx	\$xxxx

[Present second tabulation if statements are comparative.]

Common stock under exercisable options at December 31, 19X:

Year Granted	Number of Shares	Option Price	
		Per Share	Total
19T	xxx	\$xx.xx	\$xxxx
19U	xxx	\$xx.xx-xx.xx	\$xxxx
19V	xxx	\$xx.xx	\$xxxx
19W	xxx	\$xx.xx	\$xxxx

#### Stock Purchase Plan — Note Presentation

Under the Company's Employees' Stock Purchase Plan, all employees may subscribe through June, 19Y, to common shares at 90% of the market value on the date offered or purchased, whichever is lower. As of December 31, 19X, there were xxxx shares reserved for future subscriptions. Transactions are as follows:

	Shares Under Option	Price Range
Balance, January 1, 19X	xxxx	\$xx.xx
Subscriptions	xxxx	xx.xx
Purchases	( xxx )	xx.xx
Cancellations	( xxx )	xx.xx-xx.xx
Balance, December 31, 19X	<u>xxxx</u>	<u>\$xx.xx</u>

[Present second tabulation if statements are comparative.]

For stock issued during 19X, \$xxxx was charged to earnings as compensation.

## 17.600 SHAREHOLDERS' EQUITY

**17.601** The components of shareholders' equity should be disclosed either on the face of the statement or in a note to the financial statements. Any changes during the year in the capital stock outstanding, additional paid-in capital, retained earnings, treasury stock, or marketable securities valuation accounts should be disclosed in a separate statement of shareholders' equity. If the only change in shareholders' equity for the periods presented consists of the current period's earnings or losses, the changes in retained earnings can be presented in a combined statement of earnings and retained earnings.

**17.602** In the event the company has a negative balance in retained earnings or shareholders' equity, the terminology used should be descriptive. For example, the word "deficit" or "accumulated deficit" should be substituted for "retained earnings." The words "shareholders' deficit" should be used to replace "shareholders' equity."

### **Capital Stock**

**17.603** The balance sheet or notes to the financial statements should contain summary explanations of the rights and privileges of each issue of capital stock outstanding. Disclosures should consist of the following:

- A description of the security
- Par or stated values
- Shares authorized, issued and outstanding, excluding shares reacquired or held by consolidated subsidiaries
- Shares held in the treasury
- Shares reserved
- A description of any conversion terms, including prices and dates
- Any preferences as to voting rights, seniority, liquidation or dividends
- The total and per share amounts of any dividends in arrears, and the cumulative and noncumulative dividend rates
- Participation rights
- Changes in the number of shares and amounts during the periods presented
- Any sinking fund requirements

### **Additional Paid-In Capital**

**17.604** Additional paid-in capital ordinarily consists of contributed capital such as amounts received for capital stock in excess of par or stated value, recapitalization amounts, capital contributions and gains or losses on treasury stock transactions. Additional paid-in capital is permanently invested and is not available for dividends.

### **Treasury Stock**

**17.605** The cost of treasury stock, and the number of shares held, may be shown either (1) on the balance sheet as a deduction from the total of the shareholders' equity section, (2) treated as retired stock, or (3) in very rare cases, shown as an asset. However, some companies may purchase their own stock for subsequent use, and therefore, show it as an asset. For instance, if a company has a stock incentive plan, they may use the treasury stock to pay for liabilities incurred as a result of the plan. Any restrictions imposed by state laws should also be described.

## Retained Earnings

**17.606** An appropriation or segregation of retained earnings should be shown as a separate line item in the shareholders' equity section. Restrictions limiting the payment of dividends should be described in the notes to financial statements.

**17.607 Dividends.** Dividends paid on common and preferred stock should be disclosed in the statement of capital changes. The per share and total amount should be included. The per share and total amounts of cumulative dividends on senior securities in arrears should also be disclosed.

## 17.700 STATEMENT OF EARNINGS

**17.701** Chapter 18, section 18.500 includes an illustrative earnings statement.

## Sales

**17.702** Sales, net of related returns and allowances, should be presented in the earnings statement. Significant amounts of returns and allowances should be disclosed parenthetically. Sales with significant rights of return should not be included in the earnings statement.

**17.703** Information about sales to major customers should be considered for disclosure, as previously discussed in section 17.206.

## Costs of Sales

**17.704** Costs of sales should ordinarily be shown as a single line item in the earnings statement. The components of costs of sales may, depending upon the circumstances, be disclosed in the supplementary information.

**17.705** Write-downs of inventory to market values that are below cost, if material, should be disclosed in the notes to financial statements.

## Losses on Debt and Equity Securities

**17.706** Losses on debt and equity securities should be presented as a separate line item in the statement of earnings in accordance with SFAS No. 115. Such amounts are not considered extraordinary items.

## Operating Expenses

**17.707** Operating expenses are normally classified as either manufacturing, selling or general, and administrative. Manufacturing expenses are allocated to inventories and costs of sales under the full-absorption method of accounting. Selling expenses and administrative expenses are normally presented as separate line items in the earnings statement with disclosure of their components presented in the supplementary information. General and administrative expenses normally do not include interest, which is a cost of financing that is ordinarily presented as a separate line item under "Other Expenses."

## Income Taxes

**17.708** SFAS No. 109 disclosures include (see the financial statements and notes checklist in Chapter 18, section 18.200 for a more comprehensive listing of disclosures):

- Current and deferred tax expense or benefit and the amount allocated to financial statement elements other than continuing operations.
- Investment tax credits and amounts and expiration dates for tax purposes.
- Benefits of loss carryforwards and amounts and expiration dates for tax purposes.
- A reconciliation using percentages or dollar amounts of income tax expense or benefit attributable to continuing operations with the amount that would have resulted from applying domestic federal statutory tax rates (regular rate, not the AMT rate) to pretax income from continuing operations (may be omitted for nonpublic entities but the nature of the significant reconciling items must be shown).

## Tax-Exempt Entities

**17.709** A note to the financial statements should disclose that the earnings of tax-exempt business entities, such as partnerships and S Corporations, are included in the taxable income of its owners and are not subject to income taxes at the corporate level.

### Tax-Exempt Entities — Note Presentation

The shareholders of the corporation have elected under Subchapter S of the Internal Revenue Code to be taxed substantially as a partnership. The shareholders will report the entire corporate taxable income on their individual income tax returns.

## Other Income

**17.710** Other income should include nonoperating income such as dividends, interest, rents, and other investment income.

## Other Expenses

**17.711** Nonoperating expenses such as interest, casualty losses, or other items, that are either unusual or infrequent, and do not meet the criteria for extraordinary items, should be presented in this classification.

## Research and Development Costs

**17.712** Research and development costs should be charged to earnings in the period incurred and should be disclosed either on the face of the earnings statement or in a note to the financial statements. Certain exceptions exist for the production costs of computer software. See SFAS No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased or Otherwise Marketed*, for detailed guidance.

### Extraordinary Items

**17.713** Gains and losses are considered as extraordinary items only when the underlying event or transaction clearly is unusual in its nature, and is infrequent in its occurrence. To be unusual in nature, the underlying event or transaction should possess a degree of abnormality and be of a type clearly unrelated to, or only incidentally related to, the ordinary and typical activities of the entity and its environment. An infrequently occurring event or transaction would not reasonably be expected to recur in the foreseeable future, taking into account the environment in which the entity operates. The environment of a business includes, among other things, characteristics of its industry, geographical location, and any governmental regulations.

**17.714** Events and transactions meeting the above criteria should be classified as extraordinary if they are also material in relation to earnings before extraordinary items, the trend of annual earnings before extraordinary items, or if they are material by other appropriate criteria.

**17.715** Adjustments to extraordinary items reported in prior periods, which were based on judgments and facts at the time of accounting, should be classified separately and reported in the same manner as the original items, if material.

**17.716** Certain gains and losses are specifically excluded from classification as extraordinary items because they are not unusual in nature, or they may be expected to recur in the normal course of business:

- Valuation adjustments for receivables, inventories, leased equipment, or intangibles.
- Gains or losses on disposal of a segment of business or abandonment of production property, plant, or equipment.
- Effects of a strike.
- Adjustment of accruals on long-term contracts.
- The tax benefits of operating loss carryforwards.

### Prior-Period Adjustments

**17.717** SFAS No. 16, *Prior Period Adjustments*, concludes that with certain limited exceptions, items of profit or loss recognized during a period shall be included in the net earnings of that period. Exceptions are:

- Correction of an error in financial statements of the prior period.
- Certain changes in accounting principles which require retroactive application and restatement.

**17.718** Prior-period adjustments, and the related income tax effects, should be disclosed in the financial statements for the period of adjustment. If single period statements are presented, the effects of prior-period adjustments on the beginning balance of retained earnings, and on the net earnings of the preceding period, should be disclosed. When comparative statements are presented, disclosures should include the effects, net of related income taxes, on retained earnings at the beginning of each period and on net earnings for all periods.

## Discontinued Operations of a Segment of a Business

**17.719** Discontinued operations refers to a segment of a business that has been sold, abandoned, spun-off, or otherwise disposed of. It also includes such segments that, while still operating, are the subject of formal plans for disposal. A segment may consist of a subsidiary, joint venture, division, department, or other nonsubsidiary investee, provided that its assets, results of operations and activities can be clearly distinguished physically and operationally for reporting purposes from the other assets, results of operations, and activities of the company.

**17.720** Such discontinued operations should be reported as separate items on the earnings statements as a component of earnings before extraordinary items and the cumulative effect of any accounting changes. The notes to financial statements should contain the following:

- A description of the segment.
- A description of the disposal or anticipated disposal.
- A description of the manner of disposition.
- The disposal date or anticipated disposal date.
- A description of any remaining assets and liabilities of the segment.
- Earnings or losses from operations during the period and any proceeds received from the disposal of the segment, from the date management became committed to a formal plan (measurement date) up to the date of the balance sheet or completion of the disposal, whichever is earlier. If the loss on disposal cannot be estimated, that note should so state.
- Earnings or losses from discontinued operations, less related income taxes, should be disclosed on the face of the earnings statement. Such amounts should be presented as a separate line item prior to extraordinary items.
- Gains or losses on disposal of a segment of business, less related income taxes, should also be reported as a separate line item prior to extraordinary items. Such presentation is required even though the disposal may meet the criteria for extraordinary items.

**17.721** These disclosures should continue from the date management commits to the disposal until such disposal is complete.

**17.722** If comparative financial statements are being presented, the earnings statements should be reclassified to reflect the results of discontinued operations, less applicable income taxes, for all periods presented. If earnings per share data for earnings from continuing operations and net earnings are being presented on the face of the earnings statements, per share data for the results of discontinued operations and gain or loss on disposal of the business also should be included on the face of the statement or in a note to the financial statements.

**17.723** Losses on disposal of a business segment represent estimates based on judgment at the time of accounting for the event. Subsequent adjustments of such losses should be separately disclosed and classified in the same manner as the original item.



**17.724** Gains or losses resulting from involuntary conversions of property and equipment to cash ordinarily should be reported as a separate line item of earnings from continuing operations.

### **Earnings-Per-Share Data**

**17.725** Earnings-per-share data should be presented for publicly held companies whose earnings statements are designed to present the results of operations in conformity with GAAP. Such data is not required for parent company statements accompanied by consolidated statements, statements of wholly owned subsidiaries, statements of not-for-profit organizations, registered investment companies, mutual companies, or special purpose statements.

**17.726** Earnings per share data is not required for nonpublic companies. It may, however, be presented if such information is meaningful to users of the financial statements.

**17.727 Simple Capital Structure.** If the capital structure consists of common stock or other securities, including options and warrants whose conversion into common stock would reduce earnings per common share by less than 3% in total, a single presentation of "earnings per common share" is appropriate.

**17.728 Complex Capital Structure.** A dual presentation of earnings per share should be presented when the capital structure consists of common shares and other securities such as convertible debt, convertible preferred stock, options, or warrants whose conversion or exercise at the beginning of the period would have reduced earnings per share by 3% or more. Common stock issued during the year as a result of conversions or exercise, which would have caused earnings per share to be different had such issuance occurred at the beginning of the period, also will require a dual presentation of earnings per share data.

**17.729** The dual presentation consists of primary earnings per share and fully diluted earnings per share. Primary earnings per share is based on the weighted average of outstanding common stock and equivalent securities which reduce earnings per share by 3% or more. Fully diluted earnings per share consists of a pro forma presentation of the maximum potential dilution of earnings per share as if all contingent issuances of common stock had occurred.

**17.730** The terminology "earnings per common share" should be used only for simple capital structures. If there are common stock equivalents, the wording "earnings per common and common equivalent share" is appropriate. For complex structures, primary earnings per share may be designated as "earnings per common share assuming no dilution;" fully diluted earnings per share may be designated "earnings per common share assuming full dilution."

**17.731** If the earnings statements contain extraordinary items, separate earnings per share data should be presented for earnings before extraordinary items, extraordinary items, and net earnings.

**17.732** A note to the financial statements should describe the method of computation of primary and fully diluted earnings per share data. The note should include a description of all common stock equivalents included in the computation of primary earnings per share, and a description of all securities included in the fully diluted earnings per share computation. All assumptions and adjustments of earnings resulting

from conversion, and the rights of any senior security, should be described. The number of shares issued upon conversion or exercise of rights during the period should also be disclosed.

**17.733** Supplementary pro forma earnings per share data should be presented in a note to the financial statements when the following occurs during the latest period presented or shortly thereafter:

- Conversion of securities that would have affected primary earnings per share incrementally or dilutively, had the conversions been made at the beginning of the period.
- Sale of common stock equivalents or other recapitalization for the purpose of retiring preferred stock or debt.

**17.734** Supplementary earnings per share data should reflect earnings per share for the latest period presented as if the conversion or retirement had occurred at the beginning of the period or date of issue, whichever is latest. If comparative financial statements are presented, supplementary earnings per share data should be presented for all periods.

**17.735** Earnings per share computations should reflect stock dividends declared or recorded prior to the balance-sheet date, exclude treasury stock from the date of its acquisition and reflect equivalent shares of a surviving business under a pooling of interests.

**17.736** Earnings per share data should include the per share amounts of the cumulative effect of an accounting change, and the pro forma effects of primary and fully diluted earnings per share data, retroactive to the beginning of the earliest period presented. Significant changes in the accounting estimates affecting future periods and their effect on per share information should be disclosed in the note to the financial statements for the period of change.

**17.737** If discontinued operations are presented in the earnings statement, earnings per share data should be presented for earnings from continuing operations and net earnings.

**Primary Earnings Per Share — Note Presentation**

Primary earnings per share are as follows:

	<u>19X</u>	<u>19W</u>
Earnings per common and common equivalent share:		
Continuing operations	\$x.xx	\$x.xx
Discontinued operations	—	<u>x.xx</u>
Net earnings per share	<u>\$x.xx</u>	<u>\$x.xx</u>

Primary earnings per share has been computed based on the weighted average number of common shares and common share equivalents outstanding during each period. The approximate number of shares used in the computations were xxxx in 19X and xxxx in 19W. The computation of earnings per common share assuming full dilution results in less than 3% dilution in both years.

### Fully Diluted Earnings Per Share — Note Presentation

Earnings per common share consists of the following:

	<u>19X</u>	<u>19W</u>
Primary:		
Earnings before extraordinary credit	\$x.xx	\$x.xx
Extraordinary credit	<u>.xx</u>	<u>.xx</u>
Net earnings	<u>\$x.xx</u>	<u>\$x.xx</u>
Fully diluted:		
Earnings before extraordinary credit	\$x.xx	\$x.xx
Extraordinary credit	<u>.xx</u>	<u>.xx</u>
Net earnings	<u>\$x.xx</u>	<u>\$x.xx</u>
Average number of shares — primary	xxxx	xxxx
Average number of shares — fully diluted	xxxx	xxxx

Primary earnings per share has been computed based on the weighted average number of common shares and common share equivalents outstanding during each period. Fully diluted earnings per share was computed similarly and also assume that the Company's convertible notes and convertible preferred stock have been converted at the beginning of each period.

#### 17.800 SEGMENTS OF A BUSINESS ENTERPRISE

**17.801** Publicly held companies issuing a full set of year-end financial statements in accordance with GAAP are required to disclose information about various industry operations, foreign operations, export sales, and its major customers. Nonpublic companies are not required to disclose segment information.

**17.802** Section S20 of FASB *Accounting Standards — Current Text*, (AC S20) discusses the presentation of segment information, reportable industry segments, foreign operations' requirements, export sales requirements, and other information required of publicly held companies.

#### 17.900 STATEMENT OF CASH FLOWS

**17.901** A statement of cash flows is required as a basic financial statement for periods in which both a balance sheet and earnings statement are presented. In comparative financial statements, a statement of cash flows should be presented for each period for which a statement of earnings is presented. A summary of the major requirements of SFAS No. 95, *Statement of Cash Flows*, follows:

1. Cash receipts and payments should be classified as operating, investing, or financing activities.

Investing activities include making and collecting loans and acquiring and disposing of debt or equity instruments and property, plant and equipment, or other productive assets.

Financing activities include obtaining resources from owners of the entity and providing them with a return on, and return of, their investment. Financing activities also include borrowing money and repaying or otherwise settling the obligation as well as obtaining and paying for other resources obtained from creditors on long-term credit. Interest expense, and interest and dividends earned, however, should be reported as operating activities.

2. The net cash flow from operating activities can be presented by the direct or the indirect (reconciliation) method. Under the direct method, encouraged by the FASB, companies should report major classes of gross cash receipts and gross cash payments and their arithmetic sum. Under the reconciliation method, which may be the most practical for many companies, the net cash flow from operating activities is derived and presented by adjusting net income for:

- a. The effects of all deferrals of past operating cash receipts and payments, such as changes during the period in inventories or deferred income.
- b. The effects of all accruals of future operating cash receipts and payments, such as changes during the period in receivables and payables.
- c. The effects of all items whose cash effects are investing or financing cash flows, such as depreciation, amortization of goodwill, gains or losses on sales of property and equipment and discontinued operations (which relate to investing activities), and gains or losses on extinguishment of debt (which is a financing activity).

If the direct method is used, a reconciliation of net income to net cash flows for operating activities must be presented in a separate schedule. The reconciliation method, by eliminating the need to determine the gross cash receipts and gross cash payments for major classes and by providing the required reconciliation of net income to net cash flows for operating activities, should normally require the least amount of preparation time.

If the reconciliation method is used, amounts of interest paid (net of amounts capitalized) and income taxes paid during the period must be disclosed.

3. The reporting currency equivalent of foreign currency cash flows, using the current exchange rate at the time of the cash flows, should be reported as a separate line item in the reconciliation of beginning and ending balances of cash and cash equivalents. The last line in the reconciliation, after operating, investing, and financing activities, would be appropriate for the effects of exchange rate changes on cash. A weighted average exchange rate may be used if its results are approximately the same as the actual rates on the dates of the cash flows.

4. Information about noncash investing and financing activities must be provided separately. While the information can be presented either in a schedule or narrative form, a note seems most appropriate. If investing and financing activities have both cash and noncash components, such as a purchase of a building that includes a downpayment and the assumption of a mortgage, only the cash portion should be presented in the statement. To facilitate understanding by readers, the note should disclose both the cash and noncash portions of such activities.
5. The statement of cash flows must show the change in cash and, if applicable, cash equivalents derived from amounts on the balance sheet at the beginning and end of the period. Cash equivalents are short-term, highly liquid investments that are both:
  - a. Readily convertible to known amounts of cash and,
  - b. So near their maturity that they present insignificant risk of changes in value because of changes in interest rates.

Generally, only investments with original maturities (based on date purchased by the client) of three months or less qualify as cash equivalents. Treasury bills, commercial paper, money market funds and federal funds sold (for banking operations) are examples of cash equivalents. Credit card receivables for finance operations are also considered cash equivalents. The details of transactions for such cash equivalents do not have to be reported in the statement of cash flows. A description of the items included in cash equivalents must be included in the accounting policies note.

6. Information about the gross amount of cash receipts and cash payments is required except for certain items with rapid turnover, large amounts and short maturities, or for amounts being held or disbursed on behalf of customers, such as demand deposits of a bank or customer accounts payable of a broker-dealer.

**Practice Tip:**

If the entity presented its statement of cash flows in the prior period under the indirect method and is using the direct method in the current period, the auditor need not add an explanatory paragraph to his or her report noting a lack of consistency. This change in method is considered a change in classification rather than a change in accounting principle that would require a consistency paragraph.

**Practice Tip:**

An entity presenting financial statements prepared on a comprehensive basis of accounting other than generally accepted accounting principles (OCBOA) is not required to include a statement of cash flows because OCBOA statements do not purport to present financial position and results of operations in accordance with GAAP.







## CHAPTER 18

### AUDITORS' REPORTS, AND FINANCIAL STATEMENTS AND NOTES CHECKLISTS

#### Table of Contents

<b><u>Section</u></b>		<b><u>Page</u></b>
18.100	INTRODUCTION	18-3
18.101	General Comments	18-3
18.102	The Balance Sheet	18-3
18.104	Statement of Income	18-3
18.106	Statements of Retained Earnings and Shareholders' Equity	18-4
18.109	Statement of Cash Flows	18-4
18.112	Notes to Financial Statements	18-5
18.200	FINANCIAL STATEMENT DISCLOSURE CHECKLIST	18-6
18.300	AUDITORS' REPORTS CHECKLIST	18-60
18.400	ACCOUNTANTS' REPORTS ON COMPILED OR REVIEWED FINANCIAL STATEMENTS	18-64
18.500	ILLUSTRATIVE FINANCIAL STATEMENTS, NOTES, AND AUDITOR'S REPORT	18-70



## CHAPTER 18

### AUDITORS' REPORTS, AND FINANCIAL STATEMENTS AND NOTES CHECKLISTS

#### 18.100 INTRODUCTION

##### General Comments

**18.101** Illustrative financial statement formats are often helpful in developing a consistent style of presentation within a firm. However, the circumstances of engagements vary widely, and no set of illustrative financial statements can cover all situations likely to be encountered in practice, particularly when the client is engaged in a specialized industry. Accordingly, users should refer to the firm's own report files, illustrations in authoritative pronouncements, and other sources such as AICPA industry audit and accounting guides, *Accounting Trends and Techniques*, library collections of published financial reports, and the AICPA National Automated Accounting Research System (NAARS).

##### The Balance Sheet

**18.102** The companies surveyed in *Accounting Trends and Techniques*<sup>1</sup> generally use the title "balance sheet" for their statements of assets, liabilities, and shareholders' equity. Other titles used are "statement of financial position" and "statement of financial condition."

**18.103** There are two basic ways that balance sheets are arranged:

- a. Account Form — Assets are listed on the left-hand side and totaled to equal the sum of liabilities and stockholders' equity on the right-hand side.
- b. Report Form — Assets are listed at the top of the page followed by liabilities and shareholder's equity. Sometimes total liabilities are deducted from total assets to equal shareholder's equity.

##### Statement of Income

**18.104** The companies surveyed for *Accounting Trends and Techniques* generally use the term "income" in the title of their presentations of the results of operations. Other terms used are "earnings" and "operations."

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<sup>1</sup> *Accounting Trends and Techniques* (New York, AICPA) 1994, p. 143.

**18.105** The income statement is usually presented in one of the following formats:

- a. **Single-Step Format** — The single-step format groups the components of net income into two categories: (1) revenues and gains and (2) expenses and losses. The difference between the two subtotals is net income or loss for the period.
- b. **Multiple-Step Format** — The multiple-step format shows various intermediate components of net income. Generally, operating results are presented separately from nonoperating results, e.g., costs and expenses are deducted from sales followed by nonoperating revenues, gains, expenses, and losses, and are grouped by type or function. Intermediate components of net income that are frequently presented in multiple-step statements are gross profit, income from operations, and other income and expenses.

### **Statements of Retained Earnings and Shareholders' Equity**

**18.106** Although separate statements of retained earnings and statements of shareholders' equity are common presentations for public companies, their use by nonpublic companies is much less frequent. The required disclosure often can be made without presenting separate statements. This is a direct consequence of the generally much simpler capital structure of nonpublic entities and the fact that their securities are not frequently transferred.

**18.107** In most cases the only change in shareholders' equity of a nonpublic company is the change in retained earnings resulting from net income (or loss). This change can generally be adequately disclosed by expansion of the statement of income or in the balance sheet.

**18.108** When nonpublic companies do experience changes in other components of shareholders' equity, e.g., issuance of stock, purchase of treasury stock, and stock splits, disclosure is generally made in the notes or in a separate statement of changes in shareholders' equity.

### **Statement of Cash Flows**

**18.109** A statement of cash flows is required as a part of a full set of financial statements for all business enterprises.<sup>2</sup> The primary purpose of a statement of cash flows is to provide relevant information about the cash receipts and cash payments of an entity during a period.

**18.110** A statement of cash flows classifies cash receipts and payments according to whether they stem from operating, investing, or financing activities. Entities can report cash flows from operating activities directly by showing major classes of operating cash receipts and payments (the direct method).

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<sup>2</sup> In June 1993, the FASB issued SFAS No. 117, *Financial Statements of Not-for-Profit Organizations*, which, among other things, extends the requirements of SFAS No. 95 to not-for-profit organizations. This statement is effective for annual financial statements issued for fiscal years beginning after December 15, 1994, and for smaller not-for-profit organizations, the effective date is extended one year. Earlier application is encouraged.

◆

**18.111** Entities that choose not to show operating cash receipts and payments are required to report the same amount of net cash flow from operating activities indirectly by adjusting net income to reconcile it to net cash flow from operating activities (the indirect method). If the direct method is used, a reconciliation of net income and net cash flow from operating activities is required to be provided in a separate schedule.

### **Notes to Financial Statements**

**18.112** Authoritative pronouncements mandate many types of disclosures, but do not mandate the manner of presentation. Some disclosures are best presented in separate notes rather than in the basic financial statements. Descriptions of accounting policies and notes to financial statements are recognized in SAS No. 29 as components of the "basic financial statements" necessary for a fair presentation in accordance with generally accepted accounting principles. Thus, notes are an integral part of financial statements. They should be used to present material disclosures required by generally accepted accounting principles that are not otherwise presented in the statements, i.e., on the face of the statements.



### 18.200 FINANCIAL STATEMENT DISCLOSURE CHECKLIST

This checklist and the reporting checklists in sections 18.300 and 18.400 include disclosures commonly encountered in the financial statements of a corporation and reporting issues likely to be encountered by accountants who audit, compile, and review these types of financial statements. They do not include all disclosures required by GAAP or all reporting situations required by GAAS and SSARS. Further, the illustrative financial statements in section 18.500 are intended to provide sample financial statement formats and disclosures for a hypothetical corporation; they are not intended to illustrate all disclosures required by GAAP, nor do they illustrate all of the disclosures covered in the checklist.

Explanation of References:

- SFAS = Statement of Financial Accounting Standards
- FASBI = Financial Accounting Standards Board Interpretation
- APB = Accounting Principles Board Opinion
- ARB = Accounting Research Bulletin
- AIN = AICPA Accounting Interpretation
- FTB = Technical Bulletin issued by the staff of the FASB
- SOP = AICPA Statement of Position
- EITF = Emergency Issues Task Force Consensuses
- PB = AICPA Practice Bulletin
- SAS = Statement on Auditing Standards
- AC = Reference to section number in *FASB Accounting Standards—Current Text*
- AU = Reference to section number in *AICPA Professional Standards* (vol. 1)
- FASCON = Statements of Financial Accounting Concepts
- TPA = AICPA Technical Practice Aid

This checklist is organized into the sections listed below. Carefully review the topics listed and consider whether they represent potential disclosure items for the entity. Place a check mark by the topics or sections considered not applicable; these sections need not be completed. For example, if the entity did not enter into any business combinations during the year, place a check by General, Section E, "Business Combinations," and skip this section when completing the checklist.

- General
  - A. Titles and References \_\_\_\_\_
  - B. Disclosure of Accounting Policies and Other Disclosures \_\_\_\_\_
  - C. Accounting Changes \_\_\_\_\_
  - D. Comparative Financial Statements \_\_\_\_\_
  - E. Business Combinations \_\_\_\_\_
  - F. Consolidated Financial Statements \_\_\_\_\_
  - G. Related Party Transactions and Economic Dependency \_\_\_\_\_
  - H. Financial Instruments \_\_\_\_\_
  - I. Foreign Currency \_\_\_\_\_
  - J. Nonmonetary Transactions \_\_\_\_\_



K. Contingencies and Commitments (including risks and uncertainties)	_____
L. Subsequent Events	_____
M. Pension Plans	_____
N. Postretirement Benefits Other Than Pensions	_____
O. Futures Contract	_____
P. Other Matters	_____
Q. Employee Stock Ownership Plans	_____
R. Derivative Financial Instruments	_____
S. Risks and Uncertainties	_____
T. Impairment of Assets	_____
● Balance Sheet	
A. General	_____
B. Cash	_____
C. Debt and Equity Securities	_____
D. Receivables	_____
E. Inventories	_____
F. Investments	_____
G. Property and Equipment	_____
H. Lessor Leases	_____
I. Other Assets and Deferred Charges	_____
J. Current Liabilities	_____
K. Notes Payable and Other Debt	_____
L. Lessee Leases	_____
M. Other Liabilities and Deferred Credits	_____
N. Shareholders' Equity	_____
O. Changes in Shareholders' Equity	_____
● Income Statement	
A. Revenue and Expenses	_____
B. Income Taxes	_____
C. Discontinued Operations	_____
D. Extraordinary Items	_____
E. Other	_____
● Statement of Cash Flows	
A. Format	_____
B. Content	_____
● Exhibit A — Postretirement Health Care Benefits	_____





	<u>Yes</u>	<u>No</u>	<u>N/A</u>
<b>General</b>			
<b>A. Titles and References</b>			
1. Are the financial statements suitably titled? [SAS 62, par. 7 (AU 623.07)]	_____	_____	_____
2. Does each statement include a general reference that the notes are an integral part of the financial statement presentation? [Generally Accepted]	_____	_____	_____
<b>B. Disclosure of Accounting Policies and Other Disclosures</b>			
1. Is a description of all significant accounting policies of the reporting entity presented as an integral part of the financial statements? [APB 22, par. 8-9 (AC A10.102)]	_____	_____	_____
2. Does disclosure of significant accounting policies encompass important judgments as to appropriateness of principles concerning recognition of revenue, and allocation of asset costs to current and future periods? [APB 22, par. 12 (AC A10.105)]	_____	_____	_____
3. Does the disclosure of significant accounting policies include appropriate reference to details presented elsewhere (in the statements and notes thereto) so duplication of details is avoided? [APB 22, par. 14 (AC A10.107)]	_____	_____	_____
4. If the entity prepares its financial statements on a comprehensive basis of accounting other than GAAP, is disclosure made of the basis of presentation and how that basis differs from GAAP? [SAS 62, par. 10 (AU 623.10)]	_____	_____	_____
<b>C. Accounting Changes</b>			
1. For an accounting change, does disclosure in the period of the change include:			
a. Nature of the change?	_____	_____	_____
b. Justification for the change including a clear explanation why the newly adopted principle is preferable?	_____	_____	_____
c. Effect on income? [APB 20, par. 17 (AC A06.113)]	_____	_____	_____





	<u>Yes</u>	<u>No</u>	<u>N/A</u>
2. For all changes in accounting principles, except those concerning a change in entity:			
a. Are financial statements included for prior periods, for comparative purposes, as previously reported?	_____	_____	_____
b. Is the effect of the new accounting principle on income before extraordinary items and on net income and the related earnings per share amounts disclosed in the period of the change?	_____	_____	_____
c. Is income before extraordinary items and net income computed on a pro forma basis shown on the face of the income statements for all periods presented as if the newly adopted accounting principle had been applied during all periods affected? [APB 20, pars. 19 and 21 (AC A06 .115d and .121)]	_____	_____	_____
3. If appropriate, is the cumulative effect of a change in accounting principle shown separately between the captions "extraordinary items" and "net income"? [APB 20, pars. 18-26 (AC A06.114-.122 and E09.104)]	_____	_____	_____
4. If prior periods are presented, are they restated for the following special changes in accounting principles:			
a. Change from LIFO method of inventory pricing to another method?	_____	_____	_____
b. Change in method of accounting for long-term construction-type contracts?	_____	_____	_____
c. Change to or from the full cost method of accounting in extractive industries? [APB 20, pars. 27-28 (AC A06.123-.124)]	_____	_____	_____
5. Is the correction of an error shown as a prior period adjustment with disclosure of the following in the period of its discovery and correction:			
a. Nature of the error in previously issued financial statements?	_____	_____	_____
b. Effect of its correction on income before extraordinary items, net income, and related per share amounts? [APB 20, par. 36 (AC A35.105); SFAS 109, par. 288n (AC A35.103)]	_____	_____	_____



	<u>Yes</u>	<u>No</u>	<u>N/A</u>
<b>D. Comparative Financial Statements</b>			
1. Have comparative statements been considered? [ARB 43, Ch. 2A, pars. 1-2 (AC F43.101-.102)]	_____	_____	_____
2. Are the notes and other disclosures included in the financial statements of the preceding year(s) repeated, or at least referred to, to the extent that they continue to be of significance? [ARB 43, Ch. 2A, par. 2 (AC F43.102)]	_____	_____	_____
3. If changes have occurred in the manner of or basis for presenting corresponding items for two or more periods, are appropriate explanations of the changes disclosed? [ARB 43, Ch. 2A, par. 3 (AC F43.103)]	_____	_____	_____
<b>E. Business Combinations</b>			
1. If a business combination occurred during the period and met the specified conditions for a pooling of interests do the statements and notes include the required disclosures? [APB 16, pars. 45-48 and 63-65 (AC B50.104.107 and .122-.124)]	_____	_____	_____
2. If a business combination does not meet the specified conditions for a pooling of interests:			
a. Has the combination been accounted for by the purchase method? [APB 16, pars. 66-94 (AC B50.125-.147 and .159-.163); SFAS 38 (AC B50.148-.150 and .166); TB 81-2, par. 4 (AC B50.650); FASBI 4 (AC B50.151-.152) concerns research and development activities of an acquired subsidiary]	_____	_____	_____
b. Do the statements and notes include the required disclosures? [APB 16, pars. 95-96 (AC B50.164-.165); SFAS 79, pars. 4-6 (AC B50.165)]	_____	_____	_____
3. Has any portion of the valuation allowance for deferred tax assets for which subsequently recognized tax benefits will be allocated to reduce goodwill or other noncurrent intangible assets of an acquired entity or directly to contributed capital been disclosed? [SFAS 109, par. 48 (AC I27.147)]	_____	_____	_____



	<u>Yes</u>	<u>No</u>	<u>N/A</u>
4. If a material liability is recognized by the combined company for costs incurred to (1) exit an activity, (2) involuntarily terminate employees of an acquired company, or (3) relocate employees of an acquired company, are disclosures made in accordance with EITF Issue No. 95-3, <i>Recognition of Liabilities in Connection with a Purchase Business Combination</i> , in addition to the disclosures required by paragraphs 95 and 96 in APB Opinion No. 16, <i>Business Combinations</i> ? [EITF 95-3]	_____	_____	_____
<b>F. Consolidated Financial Statements</b>			
1. If consolidated statements are presented:			
a. Is the consolidation policy disclosed? [ARB 51, par. 5 (AC C51.108); APB 22, par. 13 (AC A10.106)]	_____	_____	_____
b. In instances when the financial reporting periods of subsidiaries differ from that of the parent, is recognition given to the effect of intervening events that materially affect financial position or the results of operations? [ARB 51, par. 4 (AC C51.107); FASBI 13 (AC I89.120-.122)]	_____	_____	_____
<b>G. Related-Party Transactions and Economic Dependency</b>			
1. For related-party transactions, do disclosures include:			
a. The nature of the relationships involved (e.g., parent, subsidiary and affiliate companies, officers, shareholders, etc.)?	_____	_____	_____
b. A description of the transactions, including transactions to which no amounts or nominal amounts were ascribed, for each of the periods for which income statements are presented, and such other information deemed necessary to an understanding of the effects of the transactions on the financial statements?	_____	_____	_____
c. The dollar amounts of transactions for each of the periods for which income statements are presented and the effects of any change in the method of establishing the terms from that used in the preceding period?	_____	_____	_____
d. Amounts due from or to related parties as of the date of each balance sheet presented and, if not otherwise apparent, the terms and manner of settlement? [SFAS 57, pars. 2-4 (AC R36.102-.104)]	_____	_____	_____





- |   | <u>Yes</u> | <u>No</u> | <u>N/A</u> |
|---|------------|-----------|------------|
| 2. Is the nature of a controlled relationship disclosed, even though there are no transactions between the entities, if the reporting entity and one or more other entities are under common ownership or management control and the existence of the control could result in operating results or financial position of the reporting entity significantly different from those that would have been obtained if the entity were autonomous?<br>[SFAS 57, pars. 2 and 4 (AC R36.102 and .104)] | _____      | _____     | _____      |
| 3. Are the nature and extent of leasing transactions with related parties appropriately disclosed?<br>[SFAS 13, par. 29 (AC L10.125)]   | _____      | _____     | _____      |

#### H. Financial Instruments

In October 1994, the FASB issued SFAS 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*, which expands the disclosure requirements for entities that hold or issue derivative financial instruments (see Section R. for SFAS 119 disclosures). It also amends certain disclosure requirements of SFAS 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, and SFAS 107, *Disclosures about Fair Value of Financial Instruments*. This section has been updated to reflect SFAS 119's amendments to SFAS 105 and 107. SFAS 119 is effective for fiscal years ending after December 15, 1994, except for entities with less than \$150 million in total assets in the current statement of financial position, for which the effective date is for fiscal years ending after December 15, 1995. Earlier application is encouraged. For entities that have not adopted SFAS 119, guidance is provided in certain footnotes in this section of the checklist for applying the disclosure requirements of SFAS 105 and 107 prior to adoption of SFAS 119.



	<u>Yes</u>	<u>No</u>	<u>N/A</u>
1. For financial instruments with off-balance-sheet risk (except for those excluded in SFAS 105), are the following disclosed either in the body of the financial statements or in the notes by category of financial instrument: <sup>1</sup>			
a. The face or contract amount or notional principal amount if there is no face or contract amount?	_____	_____	_____
b. The nature and terms, including, at a minimum, a discussion of:	_____	_____	_____
(1) The credit and market risk of those instruments?	_____	_____	_____
(2) The cash requirements of those instruments?	_____	_____	_____
2. Do the disclosures in Steps 1.a.-b. distinguish between financial instruments with off-balance-sheet risk held or issued for trading purposes, including dealing and other trading activities measured at fair value with gains and losses recognized in earnings, and financial instruments with off-balance-sheet risk held or issued for purposes other than trading? <sup>2</sup> [SFAS 105, par. 17, as amended by SFAS 119, par. 14 (AC F25.112A)]	_____	_____	_____
3. For financial instruments with off-balance-sheet credit risk (except for those excluded in SFAS 105), are the following disclosed either in the body of the financial statements or in the notes by category of financial instrument? <sup>3</sup>			
a. The amount of accounting loss the entity would incur if any party to the financial instrument failed completely to perform according to the terms of the contract and the collateral or other security, if any, if the amount due proved to be of no value to the entity?	_____	_____	_____

<sup>1</sup> "Category of financial instrument" refers to class of financial instrument, business activity, risk, or other category that is consistent with the management of those instruments. If disaggregation of financial instruments is other than by class, the entity also should describe for each category the classes of financial instruments included in that category. If the entity has not adopted SFAS 119, the disclosures in Steps 1.a.-b. should be made by *class* of financial instrument rather than by *category*.

<sup>2</sup> Not applicable to entities that have not adopted SFAS 119.

<sup>3</sup> See footnote 1. If the entity has not adopted SFAS 119, the disclosures in Step 3 should be made by class of financial instrument, rather than by category.





	<u>Yes</u>	<u>No</u>	<u>N/A</u>
<p>b. The entity's policy of requiring collateral or other security to support financial instruments subject to credit risk, information about the entity's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments? [SFAS 105, par. 18, as amended by SFAS 119, par. 14 (AC F25.113)]</p>	_____	_____	_____
<p>4. Do disclosures of all significant concentrations of credit risk arising from all financial instruments, whether from an individual counterparty or groups of counterparties (except those excluded in SFAS 105), include:</p>			
<p>a. Information about the (shared) activity, region, or economic characteristic that identified the concentration?</p>	_____	_____	_____
<p>b. The amount of accounting loss due to credit risk the entity would incur if parties to the financial instruments that make up the concentration failed completely to perform according to the terms of the contracts and the collateral or other security, if any, for the amount due proved to be of no value to the entity?</p>	_____	_____	_____
<p>c. The entity's policy of requiring collateral or other security to support financial instruments subject to credit risk, information about the entity's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments? [SFAS 105, par. 20 (AC F25.115)]</p>	_____	_____	_____

NOTE: The following steps relate to SFAS 107, *Disclosures about Fair Value of Financial Instruments*. For entities with less than \$150 million in total assets, the effective date for SFAS 107 is for financial statements issued for fiscal years ending after December 15, 1995. (For entities with \$150 million or more in total assets, the effective date was December 15, 1992.)



	<u>Yes</u>	<u>No</u>	<u>N/A</u>
5. Is the fair value of financial instruments for which it is practicable to estimate that value (except for those excluded in paragraphs 8 and 13 of SFAS 107) disclosed, together with the related carrying amount in a form that makes it clear whether the fair value and carrying amount represent assets or liabilities and how the carrying amounts relate to what is reported in the statement of financial position? <sup>4, 5</sup> [SFAS 107, par. 10, as amended by SFAS 119, par. 15 (AC F25.115C)]	_____	_____	_____
6. Do the disclosures in Step 5 distinguish between financial instruments held or issued for trading purposes, including dealing and other trading activities measured at fair value with gains and losses recognized in earnings, and financial instruments held or issued for purposes other than trading? [SFAS 107, par. 10, as amended by SFAS 119, par. 15 (AC F25.115C)]	_____	_____	_____
7. Are the methods and significant assumptions used to estimate the fair value of financial instruments disclosed? [SFAS 107, par. 10 (AC F25.115C)]	_____	_____	_____
8. If it is not practicable to estimate the fair market value of a financial instrument, do disclosures include:			
a. Information pertinent to estimating the fair value of the financial instrument or class of financial instruments, such as the carrying amount, effective interest rate, and maturity?	_____	_____	_____
b. The reasons why it is not practicable to estimate fair value? [SFAS 107, par. 14 (AC F25.115G)]	_____	_____	_____

<sup>4</sup> If disclosed in more than a single note, one of the notes should include a summary table containing the fair value and related carrying amounts and cross-references to the location(s) of the remaining disclosures required by SFAS 107.

<sup>5</sup> Not applicable to entities that have not adopted SFAS 119.





	<u>Yes</u>	<u>No</u>	<u>N/A</u>
9. In disclosing the fair value of a derivative financial instrument, does the entity <u>not</u> . <sup>6, 7</sup>			
a. Combine, aggregate, or net the fair value with the fair value of a nonderivative financial instrument?	_____	_____	_____
b. Net the fair value with the fair value of other derivative financial instruments? [SFAS 107, par. 13, as amended by SFAS 119, par. 15 (AC F25.115I)]	_____	_____	_____
10. For all fiscal years subsequent to the year of transition, are SFAS 107 disclosures included for each year for which a statement of financial position is presented for comparative purposes? [SFAS 107, par. 17]	_____	_____	_____
 I. Foreign Currency			
1. Is the aggregate exchange gain or loss included in net income for the period disclosed? [SFAS 52, par. 30 (AC F60.140)]	_____	_____	_____
2. Is an analysis of changes during the period in the separate component of equity for cumulative translation adjustments included, and does it disclose:			
a. Beginning and ending amount of cumulative translation adjustments?	_____	_____	_____
b. The aggregate adjustment for the period resulting from translation adjustments and gains and losses from certain hedges and intercompany balances?	_____	_____	_____
c. The amount of income taxes for the period allocated to translation adjustments?	_____	_____	_____

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<sup>6</sup> See footnote 5.

<sup>7</sup> In certain situations, offsetting may be permitted under FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*.





	<u>Yes</u>	<u>No</u>	<u>N/A</u>
d. The amounts transferred from cumulative translation adjustments and included in the determination of net income for the period as a result of the sale or complete or substantially complete liquidation of an investment in a foreign entity? [SFAS 52, par. 31 (AC F60.141)]	_____	_____	_____
3. Are rate changes occurring after the date of the financial statements and the effects on unsettled balances related to foreign currency translations disclosed, if significant? [SFAS 52, par. 32 (AC F60.142)]	_____	_____	_____
4. Are there any foreign earnings reported in addition to amounts received in the United States disclosed, if significant? [ARB 43, Ch. 12, par. 5 (AC F65.102)]	_____	_____	_____
5. Have the following disclosures in EITF 91-4 been made for hedging foreign currency risks with complex options and similar transactions? [EITF 91-4]	_____	_____	_____
6. If the entity entered into a foreign currency swap contract to replace foreign currency debt with reporting currency debt, is the contract accounted for separately and not netted against the foreign currency debt (because they are two separate legal transactions and do not have the legal right of setoff)? [EITF 86-25 (FIN 39)]	_____	_____	_____
<b>J. Nonmonetary Transactions</b>			
1. Do disclosures for nonmonetary transactions during the period include:			
a. Nature of the transactions?	_____	_____	_____
b. Basis of accounting?	_____	_____	_____
c. Gains or losses recognized on the transfers? [APB 29, par. 28, fn 7 (AC C11.102 and N35.120); FASBI 30 (AC N35.114-.119)]	_____	_____	_____
<b>K. Contingencies and Commitments</b> (Also see Section S., Risks and Uncertainties)			
1. Are the nature and amount of accrued loss contingencies including environmental matters disclosed as necessary to keep the financial statements from being misleading? [SFAS 5, par. 9 (AC C59.108)]	_____	_____	_____





	<u>Yes</u>	<u>No</u>	<u>N/A</u>
2. For loss contingencies (including environmental matters) not accrued, do disclosures indicate:			
a. Nature of the contingency?	_____	_____	_____
b. Estimate of possible loss or range of loss, or a statement that such estimate cannot be made? [SFAS 5, par. 10 (AC C59.109 and .111)]	_____	_____	_____
3. If exposure to loss exists in excess of the amount accrued for a loss contingency, do disclosures include the excess amount or state that no estimate is possible? [SFAS 5, par. 10 (AC C59.109)]	_____	_____	_____
4. Are the nature and amount of guarantees disclosed (for example, guarantee of indebtedness of others, guarantees to repurchase receivables that have been sold or otherwise assigned)? [SFAS 5, par. 12 (AC C59.113); FASBI 34, pars. 1-3 (AC C59.114)]	_____	_____	_____
5. Are gain contingencies adequately disclosed with care to avoid any misleading implications about likelihood of realization? [SFAS 5, par. 17 (AC C59.118)]	_____	_____	_____
6. Is there adequate disclosure of commitments, such as those for capital expenditures, restrictive covenants in financing agreements, inventory purchase agreements, and employment contracts? [SFAS 5, pars. 18-19 (AC C59.120)]	_____	_____	_____
7. For long-term unconditional purchase obligations associated with suppliers' financing that are not recognized, are the following disclosed:			
a. Nature of the obligations?	_____	_____	_____
b. Amount of the fixed and determinable obligations in the aggregate and for each of the next five years?	_____	_____	_____
c. Description of any portion of the obligation that is variable?	_____	_____	_____
d. Purchases under the obligations for each year for which an income statement is presented? [SFAS 47, par. 7 (AC C32.102)]	_____	_____	_____



	<u>Yes</u>	<u>No</u>	<u>N/A</u>
<b>L. Subsequent Events</b>			
1. Are the financial statements adjusted for any changes in estimates resulting from subsequent events that provide additional evidence about conditions that existed at the balance-sheet date? [SFAS 5, par. 8 (AC C59.105); SAS 1, secs. 560.03-.04, .07 & 561.01-.10 (AU 560.03-.04, .07 and 561.01-.10)]	_____	_____	_____
2. Are subsequent events that provide evidence about conditions that did not exist at the balance-sheet date but arose subsequent to that date disclosed? [SFAS 5, par. 11 (AC C59.112); APB 16, par. 61 (AC B50.120); SAS 1, secs. 560.05-.07, .09 & 561.01-.10 (AU 560.05-.07, .09 and 561.01-.10)]	_____	_____	_____
<b>M. Pension Plans</b> (For defined benefit plans, the accounting and reporting by the plans should be in conformity with SFAS 35.)			
1. If there is a defined benefit plan, do disclosures include:			
a. A description of the plan including employee groups covered, type of benefit formula, funding policy, types of assets held and significant nonbenefit liabilities, if any, and the nature and effect of significant matters affecting comparability of information for all periods presented? [SFAS 87, par. 54a (AC P16.150a)]	_____	_____	_____
b. The amount of net periodic pension cost for the period showing separately the service cost component, the interest cost component, the actual return on assets for the period, and the net total of other components? <sup>8</sup> [SFAS 87, par. 54b (AC P16.150b)]	_____	_____	_____

<sup>8</sup> The net total of other components is the net effect during the period of certain delayed recognition provisions of SFAS 87. That net total includes:

- a. The net asset gain or loss during the period deferred for later recognition (in effect, an offset or a supplement to the actual return on assets).
- b. Amortization of the net gain or loss from earlier periods.
- c. Amortization of unrecognized prior service cost.
- d. Amortization of the unrecognized net obligation or net asset existing at the date of initial application of SFAS 87 [AC P16].



	<u>Yes</u>	<u>No</u>	<u>N/A</u>
c. All amounts shown within three months of the balance-sheet date using a consistent date from year to year?	___	___	___
d. A schedule reconciling the funded status of the plan with amounts reported in the employer's statement of financial position, showing separately:			
(1) The fair value of plan assets?	___	___	___
(2) The projected benefit obligation identifying the accumulated benefit obligation and the vested benefit obligation?	___	___	___
(3) The amount of unrecognized prior service cost?	___	___	___
(4) The amount of unrecognized net gain or loss (including asset gains and losses not yet reflected in market-related value)?	___	___	___
(5) The amount of any remaining unrecognized net obligation or net asset existing at the date of initial application of SFAS 87 [AC P16]?	___	___	___
(6) The amount of any additional liability recognized pursuant to SFAS 87, paragraph 36 [AC P16.130]?	___	___	___
(7) The amount of net pension asset or liability recognized in the statement of financial position pursuant to SFAS 87, paragraphs 35-36 [AC P16.129-.130] (which is the net result of combining the preceding six items)?	___	___	___
e. The weighted-average assumed discount rate and rate of compensation increase (if applicable) used to measure the projected benefit obligation and the weighted-average expected long-term rate of return on plan assets? [SFAS 87, par. 54d (AC P16.150d)]	___	___	___
f. If applicable, the amount and types of securities of the employer and related parties included in plan assets, and the approximate amount of annual benefits of employees and retirees covered by annuity contracts issued by the employer and related parties. [SFAS 87, par. 54 (AC P16.150)]	___	___	___
g. If applicable, the alternative amortization methods used pursuant to SFAS 87, paragraphs 26 and 33 [AC P16.120 and .127], and the existence and nature of the commitment discussed in paragraph 41 [AC P16.135]?	___	___	___



	<u>Yes</u>	<u>No</u>	<u>N/A</u>
h. If more than one defined benefit plan exists:			
(1) Are the disclosures required by Step M.1 above aggregated for all of the employer's single employer defined benefit plans or disaggregated in groups so as to provide the most useful information?	_____	_____	_____
(2) Are plans with assets in excess of accumulated benefit obligation not aggregated with plans that have accumulated benefit obligations that exceed plan assets?	_____	_____	_____
(3) Are disclosures for plans outside the U.S. not combined with those for U.S. plans unless those plans use similar economic assumptions? [SFAS 87, par. 56 (AC P16.153)]	_____	_____	_____
2. If there is a defined contribution plan, do disclosures include:			
a. A description of the plan including employee groups covered, the basis for determining contributions, and the nature and effect of significant matters affecting comparability of information for all periods presented?	_____	_____	_____
b. The amount of cost recognized during the period? [SFAS 87, par. 65 (AC P16.162)]	_____	_____	_____
3. If the substance of a plan having characteristics of both defined benefits and contributions is to provide a defined benefit, are disclosures with the requirements described in Step M.1. above made? [SFAS 87, par. 66 (AC P16.163)]	_____	_____	_____
4. If there is a multiemployer plan, do disclosures include:			
a. A description of the multiemployer plan including the employee groups covered, the type of benefits provided (defined benefit or defined contribution), and the nature and effect of significant matters affecting comparability of information for all periods presented?	_____	_____	_____
b. The amount of cost recognized during the period? [SFAS 87, par. 69 (AC P16.166)]	_____	_____	_____





	<u>Yes</u>	<u>No</u>	<u>N/A</u>
c. If the situation arises where it is probable or reasonably possible that the employer's withdrawal from a multiemployer plan will result in the employer having an obligation to the plan for a portion of its unfunded benefit obligations, have the provisions of SFAS 5 been applied? [SFAS 87, par. 70 (AC P16.167)]	_____	_____	_____
5. If there is a settlement or curtailment of a defined benefit pension plan or termination of benefits under such plan, do disclosures include:			
a. A description of the nature of the event(s)?	_____	_____	_____
b. The amount of gain or loss recognized? [SFAS 88, par. 17 (AC P16.187)]	_____	_____	_____
<b>N. Postretirement Benefits Other Than Pensions (See Exhibit A)</b>			
1. If there are one or more defined benefit postretirement plans, do disclosures include:			
a. A description of the substantive plan(s) that is the basis for the accounting, including the nature of the plan, any modifications of the existing cost-sharing provisions that are encompassed by the substantive plan(s), and the existence and nature of any commitment to increase monetary benefits provided by the plan, employee groups covered, types of benefits provided, funding policy, types of assets held and significant nonbenefit liabilities, and the nature and effect of significant matters affecting the comparability of information for all periods presented, such as the effect of a business combination or divestiture?	_____	_____	_____
b. The amount of net periodic postretirement benefit cost showing separately the service cost component, the interest cost component, the actual return on plan assets for the period, amortization of the unrecognized transition obligation or transition asset, and the net total of other components? <sup>9</sup>	_____	_____	_____

<sup>9</sup> The net total of other components is generally the net effect during the period of certain delayed recognition provisions of SFAS 106 [ACP40]. That net total includes:

- a. The net asset gain or loss during the period deferred for later recognition (in effect, an offset or a supplement to the actual return on plan assets).
- b. Amortization of unrecognized prior service cost.
- c. Amortization of the net gain or loss from earlier periods.
- d. Any gain or loss recognized due to a temporary deviation from the substantive plan (paragraph 61 of SFAS 106 [AC P40.156]).



	<u>Yes</u>	<u>No</u>	<u>N/A</u>
c. A schedule reconciling the funded status of the plan(s) with amounts reported in the employer's statement of financial position, showing separately:			
1) The fair value of plan assets?	_____	_____	_____
2) The accumulated postretirement benefit obligation, identifying separately the portion attributable to retirees, other fully eligible plan participants, and other active plan participants?	_____	_____	_____
3) The amount of unrecognized prior service cost?	_____	_____	_____
4) The amount of unrecognized net gain or loss (including plan asset gains and losses not yet reflected in market-related value)?	_____	_____	_____
5) The amount of any remaining unrecognized transition obligation or transition asset?	_____	_____	_____
6) The amount of net postretirement benefit asset or liability recognized in the statement of financial position, that is the net result of combining the preceding five items?	_____	_____	_____
d. The assumed health care cost trend rate(s) used to measure the expected cost of benefits covered by the plan (gross eligible changes) for the next year and a general description of the direction and pattern of change in the assumed trend rate(s) thereafter, together with the ultimate trend rate(s) and when the rate(s) is expected to be achieved?	_____	_____	_____
e. The weighted-average of the assumed discount rate(s) and rate(s) of compensation increase (for pay-related plans) used to measure the accumulated postretirement benefit obligation and the weighted-average of the expected long-term rate(s) of return on plan assets and, for plans whose income is segregated from the employer's investment income for tax purposes, the estimated income tax rate(s) included in that rate of return?	_____	_____	_____
f. The effect of a one-percentage point increase in the assumed health care cost trend rates for each future year on:			
1) The aggregate of the service and interest cost components of net periodic postretirement health care benefit cost?	_____	_____	_____





	<u>Yes</u>	<u>No</u>	<u>N/A</u>
<p>2) The accumulated postretirement benefit obligation for health care benefits (For purposes of this disclosure, all other assumptions shall be held constant and the effects shall be measured based on the substantive plan that is the basis for the accounting)?</p>	_____	_____	_____
<p>g. The amounts and types of securities of the employer and related parties included in plan assets, and the approximate amount of future annual benefits of plan participants covered by insurance contracts issued by the employer and related parties?</p>	_____	_____	_____
<p>h. Any alternative amortization method used pursuant to paragraphs 53 or 60 of SFAS 106 [ACP40.148 or .155]?</p>	_____	_____	_____
<p>i. The amount of gain or loss recognized during the period for a settlement or curtailment and a description of the nature of the event(s)?</p>	_____	_____	_____
<p>j. The cost of providing special or contractual termination benefits recognized during the period and a description of the nature of the event(s)? [SFAS 106, par. 74a-j (AC P40.169a-j)]</p>	_____	_____	_____
<p>k. The transition provisions required under SFAS 106? [SFAS 106, pars. 108-115 (AC Appendix C, pgs. 13-15)]</p>	_____	_____	_____
<p>2. If more than one defined benefit postretirement plan exists:</p>			
<p>a. Have the disclosures required by Step N.1 above been aggregated for all of an employer's single-employer defined benefit postretirement plans or disaggregated in groups so as to provide the most useful information (except for purposes of the disclosures required by Step N.1.c above, the aggregate plan assets and the aggregate accumulated postretirement benefit obligation of the underfunded plans should be separately disclosed)? [SFAS 106, par. 77 (AC P40.172)]</p>	_____	_____	_____
<p>b. Are plans that provide primarily postretirement healthcare benefits and plans that provide primarily other postretirement welfare benefits separately disclosed if the accumulated postretirement benefit obligation of the latter plans is significant relative to the aggregate accumulated postretirement benefit obligation for all the plans? [SFAS 106, par. 78 (AC P40.173)]</p>	_____	_____	_____





	<u>Yes</u>	<u>No</u>	<u>N/A</u>
<p>c. Are plans inside and outside the U.S. separately disclosed if the accumulated postretirement benefit obligation of the latter plans is significant relative to the aggregate accumulated postretirement benefit obligation for all plans? [SFAS 106, par. 78 (AC P40.173)]</p>	_____	_____	_____
<p>3. If there is a multiemployer plan, do disclosures include:</p>			
<p>a. A description of the plan including the employee groups covered, the type of benefits provided (defined benefits or defined contribution), and the nature and effect of significant matters affecting comparability of information for all periods presented?</p>	_____	_____	_____
<p>b. The amount of postretirement benefit cost recognized during the period, if available; otherwise, the amount of the aggregate required contribution for the period to the general health and welfare benefit plan that provides health and welfare benefits to both active employees and retirees? [SFAS 106, par. 82a-b (AC P40.178)]</p>	_____	_____	_____
<p>c. In some situations, an employer's withdrawal from a multiemployer plan may result in an employer's having an obligation to the plan for a portion of the plan's unfunded accumulated postretirement benefit obligation. Have the provisions of SFAS 5 been applied if it is probable or reasonably possible that:</p>			
<p>(1) An employer's withdrawal from the plan would give rise to an obligation?</p>	_____	_____	_____
<p>(2) The company's contribution to the fund will be increased during the remainder of the contract period to make up a shortfall in the funds necessary to maintain the negotiated level of benefit coverage? [SFAS 106, par. 83 (AC P40.179)]</p>	_____	_____	_____
<p>4. If there are one or more defined contribution postretirement plans, are the following items disclosed separately from defined benefit postretirement plan disclosures:</p>			
<p>a. A description of the plan(s) including employee groups covered, the basis for determining contributions, and the nature and effect of significant matters affecting comparability of information for all periods presented?</p>	_____	_____	_____





	<u>Yes</u>	<u>No</u>	<u>N/A</u>
b. The amount of cost recognized during the period? [SFAS 106, par. 106 (AC P40.198)]	_____	_____	_____
<b>O. Futures Contracts</b>			
If a futures contract is accounted for as a hedge, is the following disclosed?			
a. The nature of the assets, liabilities, firm commitments, or anticipated transactions that are hedged with futures contracts.	_____	_____	_____
b. The method of accounting for the futures contract, including a description of the events or transactions that result in recognition in income of changes in value of the futures contract. [SFAS 80, par. 12 (AC F80.112)]	_____	_____	_____
<b>P. Other Matters</b>			
1. If required by SFAS 21 [AC S20], is segment information disclosed? [SFAS 14 (AC S20); SFAS 24, par. 5 (AC S20.109-.110); SFAS 30, par. 6 (AC S20.145)]	_____	_____	_____
2. If an obligation for postemployment benefits (other than pensions) is not accrued in accordance with SFAS 5 or 43 only because the amount cannot reasonably be estimated, is that fact disclosed? [SFAS 112, par. 7 (AC P32.105)]	_____	_____	_____
<b>Q. Employee Stock Ownership Plans</b>			
1. If an employer sponsors an employee stock ownership plan (ESOP), do the employer's disclosures include:			
a. A description of the plan, the basis for determining contributions, including the employee groups covered, and the nature and effect of significant matters affecting comparability of information for all periods presented?	_____	_____	_____
(1) For leveraged ESOPs and pension reversion ESOPs, does the description include the basis for releasing shares and how dividends on allocated and unallocated shares are used?	_____	_____	_____
b. A description of the accounting policies followed for ESOP transactions, including the method of measuring compensation, the classification of dividends on ESOP shares, and the treatment of ESOP shares for earnings per share (EPS) computations?	_____	_____	_____



	<u>Yes</u>	<u>No</u>	<u>N/A</u>
(1) If the entity has both old ESOP shares for which it does not adopt the guidance in SOP 93-6 and new ESOP shares for which the guidance in SOP 93-6 is required, are the accounting policies for both blocks of shares disclosed?	_____	_____	_____
c. The amount of compensation cost recognized during the period?	_____	_____	_____
d. The number of allocated shares, committed-to-be-released shares, and suspense shares held by the ESOP at the balance-sheet date?	_____	_____	_____
(1) If the entity has both old ESOP shares for which it does not adopt the guidance in SOP 93-6 and new ESOP shares for which the guidance in SOP 93-6 is required, is the above disclosure made separately for both blocks of shares?	_____	_____	_____
e. The fair value of unearned ESOP shares at the balance-sheet date for shares accounted for under SOP 93-6? <sup>10</sup>	_____	_____	_____
f. The existence and nature of any repurchase obligation, including disclosure of the fair value of the shares allocated as of the balance-sheet date, which are subject to a repurchase obligation? <sup>11</sup> [SOP 93-6, par. 53]	_____	_____	_____
2. Are all the items listed in Step 3. above disclosed even if the employer with an ESOP does not adopt SOP 93-6 for shares held by the ESOP on December 31, 1992? [SOP 93-6, par. 55]	_____	_____	_____
3. For leveraged and nonleveraged ESOPs where the assets from a terminated defined benefit pension plan are used by the ESOP to purchase shares, when the employer reports the issuance of shares or the sale of treasury shares to the ESOP, is the charge to unearned ESOP shares presented as a separate item in the balance sheet as a contra-asset account? [SOP 93-6, pars. 13 and 46]	_____	_____	_____
4. If the employer sponsors an ESOP with an indirect loan, is the outside loan reported as a liability and the receivable from the ESOP <b>not</b> reported as an asset on the employer's balance sheet? [SOP 93-6, par. 26]	_____	_____	_____

<sup>10</sup> This disclosure need not be made for old ESOP shares for which the entity does not apply the guidance in SOP 93-6.

<sup>11</sup> Employers may wish to disclose additional information about the obligation, particularly information about the timing of payments. [SOP 93-6, par. 95]





	<u>Yes</u>	<u>No</u>	<u>N/A</u>
5. If the employer sponsors an ESOP with an employer loan, is the employer's note receivable from the ESOP <b>not</b> reported in the employer's balance sheet? [SOP 93-6, par. 27]	_____	_____	_____
<b>R. Derivative Financial Instruments.</b>			
(SFAS 119 is effective for financial statements issued for fiscal years ending after December 15, 1994, except for entities with less than \$150 million in total assets, for which the effective date is fiscal years ending after December 15, 1995.)			
1. For options held and other derivative financial instruments not within the scope of SFAS 105 (because they do not have off-balance-sheet risk of accounting loss), are the following disclosures made by category of financial instrument:			
a. The face or contract amount (or notional principal amount if there is no face or contract amount)? <sup>12</sup>	_____	_____	_____
b. The nature and terms, including at a minimum a discussion of:			
(1) Credit and market risk?	_____	_____	_____
(2) Cash requirements?	_____	_____	_____
(3) Related accounting policy as required by APB 22?	_____	_____	_____
c. Do disclosures in Steps 1.a. and b. above distinguish between financial instruments held or issued for:			
(1) Trading purposes, including dealing and other trading activities measured at fair value with gains and losses recognized in earnings?	_____	_____	_____
(2) Purposes other than trading? [SFAS 119, pars. 8 and 9]	_____	_____	_____

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<sup>12</sup> Unless, as described in footnote 2 of SFAS 119, the disclosure of the face or contract amount would be misleading because the instruments are leveraged and the leverage features are not adequately disclosed.



	<u>Yes</u>	<u>No</u>	<u>N/A</u>
2. If the entity holds or issues derivative financial instruments for trading purposes, has it disclosed:			
a. The average fair value during the reporting period and the related end-of-period fair value, distinguishing between assets and liabilities?	_____	_____	_____
b. The net gains or losses (net trading revenue) arising from trading activities during the reporting period disaggregated by class, business activity, risk or other category consistent with management of those activities and where those net trading gains or losses are reported in the income statement?	_____	_____	_____
(1) If the disaggregation is other than by class, has entity also disclosed for each category the classes of derivative financial instruments, other financial instruments and nonfinancial assets and liabilities from which the net trading gains and losses arose?	_____	_____	_____
c. The average fair value for assets and liabilities from the trading of other types of financial instruments or nonfinancial assets? (This disclosure is encouraged but not required.) [SFAS 119, par.10]	_____	_____	_____
3. If the entity holds or issues derivative financial instruments for purposes other than trading, has it disclosed:			
a. A description of:			
(1) The objectives for holding or issuing?	_____	_____	_____
(2) The context needed to understand those objectives?	_____	_____	_____
(3) The strategies for achieving those objectives?	_____	_____	_____
(4) The classes of derivative financial instruments used?	_____	_____	_____
b. A description of how each class of derivative financial instrument is reported in the financial statements, including:			
(1) The policies for recognition and measurement or nonrecognition of the derivative financial instruments?	_____	_____	_____
(2) When recognized, where the instruments and related gains and losses are reported?	_____	_____	_____





	<u>Yes</u>	<u>No</u>	<u>N/A</u>
c. For derivative financial instruments that are held or issued and accounted for as hedges of anticipated transactions, both firm and forecasted transactions for which there is no firm commitment, including:			
(1) A description of the anticipated transactions whose risks are hedged, including the expected time period of occurrence?	___	___	___
(2) A description of the classes of derivative financial instruments used to hedge?	___	___	___
(3) The amount of explicitly deferred hedging gains and losses?	___	___	___
(4) A description of the transaction or events that result in the recognition in earnings of the deferred gains or losses? [SFAS 119, par. 11]	___	___	___
4. Is quantitative information about the following considered for disclosure (encouraged, but not required)?			
a. Interest rate.	___	___	___
b. Foreign exchange.	___	___	___
c. Commodity price.	___	___	___
d. Other market risks consistent with management's strategies.	___	___	___
e. Information about the risks of other financial instruments or nonfinancial assets and liabilities to which the derivative financial instruments are related? <sup>13</sup> [SFAS 119, pars. 12 and 13]	___	___	___

<sup>13</sup> Suggested methods of disclosure of this information include:

- a. Additional details about current positions and activity.
- b. Hypothetical effects on equity or annual income of several possible changes in market prices.
- c. Gap analysis of interest rate repricing or maturity dates.
- d. Duration of the financial instruments.
- e. The entity's value at risk from derivative financial instruments and other positions at year end and the average value at risk during the year.



S. Risks and Uncertainties

SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, is effective for financial statements issued for fiscal years ending after December 15, 1995, and for financial statements for interim periods in fiscal years subsequent to the year for which this SOP is to be first applied. Early application is encouraged but not required. (Also see Section K, Commitments and Contingencies.)

Yes    No    N/A

- |   |  |  |  |
|---|--|--|--|
| <p>1. Is a description of the major products and services the entity sells or provides and the principal markets, including the location of those markets disclosed?<br/>[SOP 94-6, par. 10]</p> <p>2. If the entity operates in more than one business, are the relative importance of its operations in each business and the basis for the determination (for example, assets, revenues, or earnings) disclosed?<br/>[SOP 94-6, par. 10]</p> <p>3. Is an explanation that the preparation of financial statements in conformity with GAAP requires the use of management's estimates included?<br/>[SOP 94-6, par. 11]</p> <p>4. Is disclosure regarding an estimate made when known information available before the financial statements are issued indicates that: (a) it is at least reasonably possible that the estimate of the effect on the financial statements of a condition, situation, or set of circumstances that existed the date of the financial statements will change in the near term due to one or more future confirming events, and (b) the effect of the change would be material to the financial statements?<br/>[SOP 94-6, par. 13]</p> <p>5. Does the disclosure in Step 4 above indicate the nature of the uncertainty and include an indication that it is at least reasonably possible that a change in estimate will occur in the near term?<sup>14</sup><br/>[SOP 94-6, par. 14]</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> |
|---|--|--|--|

<sup>14</sup> If risk reduction techniques are used to mitigate losses or the uncertainty that may result from certain events, these disclosures are encouraged but not required.





	<u>Yes</u>	<u>No</u>	<u>N/A</u>
6. If the estimate in Step 4 above involves a loss contingency covered by SFAS 5, <i>Accounting for Contingencies</i> , do disclosures include an estimate of the possible loss or range of loss, or state that such an estimate cannot be made. <sup>14</sup> [SOP 94-6, par. 14]	_____	_____	_____
7. Is disclosure of the concentrations described in paragraph 22 of SOP 94-6 made if, based on information known to management before the financial statements are issued, the criteria in paragraph 21 of SOP 94-6 are met? [SOP 94-6, pars. 21-22]	_____	_____	_____
8. For those concentrations of labor subject to collective bargaining agreements and concentrations of operations located outside the entity's home country that meet the criteria of paragraph 21 of SOP 94-6, are the following disclosed?	_____	_____	_____
a. The percentage of labor force covered by a collective agreement and the percentage of the labor force covered by a collective bargaining agreement that will expire in one year.	_____	_____	_____
b. The carrying amounts of net asses and the geographic areas in which they are located for operations located outside the entity's home country? [SOP 94-6, par. 10]	_____	_____	_____
 T. Impairment of Assets			
SFAS 121, <i>Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of</i> , is effective for financial statements for fiscal years beginning after December 15, 1995; however; earlier application is encouraged. Restatement of previously issued financial statements is not permitted.			
1. If an impairment loss is recognized for assets to be held and used, do disclosures include:			
a. A description of the impaired assets and the facts and circumstances leading to the impairment?	_____	_____	_____
b. The amount of the impairment loss and how fair value was determined?	_____	_____	_____





	<u>Yes</u>	<u>No</u>	<u>N/A</u>
c. The caption in the income statement in which the impairment loss is aggregated if that loss is not presented as a separate caption or reported parenthetically on the face of the statement.	_____	_____	_____
d. The business segment(s) affected, if applicable. [SFAS 121, par. 14]	_____	_____	_____
2. If assets to be disposed of are accounted for in accordance with paragraphs 15-17 of SFAS 121, do disclosures include:			
a. A description of assets to be disposed of, the facts and circumstances leading to the expected disposal, the expected disposal date, and the carrying amount of those assets?	_____	_____	_____
b. The business segment(s) in which assets to be disposed of are held, if applicable?	_____	_____	_____
c. The loss, if any, resulting from applying paragraph 15 of SFAS 121?	_____	_____	_____
d. The gain or loss, if any, resulting from changes in the carrying amounts of assets to be disposed of that arises from applying paragraph 17 of SFAS 121?	_____	_____	_____
e. The caption in the income statement in which the gains or losses in Steps 2.c. and d. are aggregated if those gains or losses are not presented as a separate caption or reported parenthetically on the face of the statement?	_____	_____	_____
f. The results of operations for assets to be disposed of to the extent that those results are included in the entity's results of operations for the period and can be identified? [SFAS 121, par. 19]	_____	_____	_____
3. If an impairment loss is recognized, is it reported as a component of income from continuing operations before income taxes? [SFAS 121, pars. 13 and 18]	_____	_____	_____





	<u>Yes</u>	<u>No</u>	<u>N/A</u>
<b>Balance Sheet</b>			
<b>A. General</b>			
1. For classified balance sheets, are assets and liabilities segregated into current and noncurrent classifications with totals presented for current assets and current liabilities? [ARB 43, Ch. 3A, pars. 2-8 (AC B05.103-.109); SFAS 6, par. 15 (AC B05.118); FASBI 8, par. 3 (AC B05.117); TB 79-3 (AC B05.501-.503)]	_____	_____	_____
2. Are assets not expected to be realized during the current operating cycle classified as noncurrent? [ARB 43, Ch. 3A, pars. 5-6 (AC B05.106-.107)]	_____	_____	_____
<b>B. Cash</b>			
1. Is separate disclosure made of restricted cash? [ARB 43, Ch. 3A, par. 6 (AC B05.107)]	_____	_____	_____
<b>C. Debt and Equity Securities</b>			
1. For debt and marketable equity securities classified as available-for-sale or held-to-maturity, are the following disclosures made, by major security type, for each balance sheet presented?			
a. Aggregate fair value.	_____	_____	_____
b. Gross unrealized holding gains and losses.	_____	_____	_____
c. Amortized cost basis. [SFAS 115, par. 19 (AC I80.118)]	_____	_____	_____
2. For investments in debt securities classified as available-for-sale or held-to-maturity, is:			
a. Disclosure made about their contractual maturities, as of the date of the latest balance-sheet date presented? (Maturity information may be combined in appropriate groupings.) [SFAS 115, par. 20 (AC I80.119)]	_____	_____	_____
<b>D. Receivables</b>			
1. Are accounts and notes receivable from officers, employees, and affiliated companies shown separately with appropriate disclosures? [ARB 43, Ch. 1A, par. 5 (AC R36.105)]	_____	_____	_____



	<u>Yes</u>	<u>No</u>	<u>N/A</u>
2. Are unbilled receivables (e.g., unbilled costs and fees under cost-plus-fixed-fee contracts) shown separately from billed receivables? [ARB 43, Ch. 11A, par. 4]	_____	_____	_____
3. Are unearned finance charges and interest included in the face amounts of receivables shown as a deduction from the related receivables? [APB 6, par. 14 (AC B05.107a)]	_____	_____	_____
4. If a note is noninterest bearing or has an inappropriate stated interest rate:			
a. Is the discount or premium presented as a deduction from or addition to the face amount of the note?	_____	_____	_____
b. Does the disclosure include the effective interest rate and face amount of the note?	_____	_____	_____
c. Is amortization of discount or premium reported as interest in the income statement? [APB 21, par. 16 (AC I69.109)]	_____	_____	_____
5. Is the unamortized balance of loan origination, commitment, and other fees and costs and purchase premiums and discounts that is being recognized as an adjustment of yield reported as part of the loan balance to which it relates? [SFAS 91, par. 21 (AC L20.120)]	_____	_____	_____
6. Are allowances for uncollectible receivables shown as deductions from the related receivables? [APB 12, par. 3 (AC V18.102)]	_____	_____	_____
7. For troubled debt restructurings, are the following disclosed by major category of receivables for each balance sheet presented?			
a. Aggregate recorded investment.	_____	_____	_____
b. Gross interest income that would have been recorded if receivables had been current per their original terms.	_____	_____	_____
c. Amount of interest income included in net income.	_____	_____	_____
d. Amounts of any commitments to lend additional funds to debtors owing restructured troubled receivables. [SFAS 15, pars. 40-41 (AC D22.136-.137)]	_____	_____	_____





	<u>Yes</u>	<u>No</u>	<u>N/A</u>
8. For transfers of receivables with recourse that are reported as sales, are the following disclosed?			
a. The proceeds to the transferors during each period for which an income statement is presented.	_____	_____	_____
b. The balance of the receivables transferred that remain uncollected at the date of each balance sheet presented, if such information is available. [SFAS 77, par. 9 (AC R20.109)]	_____	_____	_____
9. If the effect of discounting the recourse obligation is material, are the undiscounted amount of the recourse and the interest note disclosed? [EITF 92-2]	_____	_____	_____
<b>E. Inventories</b>			
1. Are the major classes of inventory disclosed (e.g., finished goods, work in process, raw materials)? [ARB 43, Ch. 3A, par. 4 (AC B05.105)]	_____	_____	_____
2. Is the method of determining inventory cost (e.g., LIFO, FIFO) disclosed? [ARB 43, Ch. 3A, par. 9 (I78.120)]	_____	_____	_____
3. Is the basis for stating inventory disclosed (e.g., lower of cost or market) and, if necessary, the nature of a change in basis for stating inventory, and the effect on income of such a change? [ARB 43, Ch. 4, pars. 4-16 (AC I78.104-.117 and .119-.120); APB 22, par. 13 (AC A10.106)]	_____	_____	_____
4. Are valuation allowances for inventory losses shown as a deduction from the related inventory? [APB 12, par. 3 (AC V18.102)]	_____	_____	_____
<b>F. Investments</b>			
1. Are the appropriate disclosures made for investments in common stock accounted for by the equity method? [APB 18, par. 20 (AC I82.110)]	_____	_____	_____



	<u>Yes</u>	<u>No</u>	<u>N/A</u>
<b>G. Property and Equipment</b>			
1. For depreciable assets, do the financial statements or notes thereto include disclosure of:			
a. Depreciation expense for each period? [APB 12, par. 5a (AC D40.105a)]	_____	_____	_____
b. Balances of major classes of depreciable assets by nature or function? [APB 12, par. 5b (AC D40.105b)]	_____	_____	_____
c. Accumulated depreciation, either by major classes of assets or in total? [APB 12, par. 5c (AC D40.105c)]	_____	_____	_____
d. The method or methods used in computing depreciation for each major class of depreciable assets? [APB 12, par. 5d (AC D40.105d); APB 22, par. 13 (AC A10.106)]	_____	_____	_____
2. Are net assets and liabilities of discontinued segments segregated from the assets and liabilities of continuing operations? [APB 30, par. 18d (AC I13.108d)]	_____	_____	_____
3. Do discussions of interest cost include:			
a. For periods in which no interest cost is capitalized, the amount of interest cost charged to expense during the period?	_____	_____	_____
b. For periods in which some interest cost is capitalized, the total amount of interest cost incurred during the period and the amount that has been capitalized? [SFAS 34, par. 21 (I67.118)]	_____	_____	_____
<b>H. Lessor Leases</b>			
1. For sales-type and direct financing leases, do disclosures include:			
a. Appropriate components of the net investment in the leases as of the date of each balance sheet presented?	_____	_____	_____
b. Future minimum lease payments (with separate deductions for minimum lease payments and allowances for uncollectable minimum lease payments receivable) for each of the five succeeding fiscal years as of the latest balance sheet date presented?	_____	_____	_____



	<u>Yes</u>	<u>No</u>	<u>N/A</u>
c. Total contingent rentals included in income for each period for which an income statement is presented? [SFAS 13, par. 23a (AC L10.119a)]	_____	_____	_____
d. For direct financing leases, the amount of initial direct costs as part of the investment?	_____	_____	_____
e. Unguaranteed residual values accruing to the benefit of the lessor?	_____	_____	_____
f. Unearned income? [SFAS 91, par. 25d (AC L10.119(a) (1))]	_____	_____	_____
2. For operating leases, do disclosures include:			
a. Cost and carrying amount of property on lease or held for leasing by major classes and the amount of accumulated depreciation as of the date of the latest balance sheet presented?	_____	_____	_____
b. Minimum future rentals on noncancelable leases as of the date of the latest balance sheet presented in the aggregate and for each of the five succeeding fiscal years?	_____	_____	_____
c. Total contingent rentals included in income for each period for which an income statement is presented? [SFAS 13, par. 23b (AC L10.119b)]	_____	_____	_____
3. Do disclosures include a general description of the lessor's leasing arrangements? [SFAS 13, par. 23 (AC L10.119c)]	_____	_____	_____
I. Other Assets and Deferred Charges			
1. Are issue costs of debt reported as deferred charges? [APB 21, par. 16 (AC I69.109)]	_____	_____	_____
2. Do disclosures include the method and period of amortization? [APB 17, pars. 27-31 (AC I60.108-.112); APB 22, par. 13 (AC A10.106)]	_____	_____	_____
3. Are deferred tax assets determined for each tax-paying component (an individual entity or group of entities that is consolidated for tax purposes) in each tax jurisdiction presented separately? [SFAS 109, par. 17 (ACI27.116)]	_____	_____	_____
4. Are deferred tax assets classified as current or noncurrent based on the classification of the related asset or liability? [SFAS 109, par. 41 (ACI27.140)]	_____	_____	_____



	<u>Yes</u>	<u>No</u>	<u>N/A</u>
5. Are deferred tax assets not related to an asset or liability, including those related to carryforwards, classified according to the expected reversal date of the temporary difference pursuant to SFAS 37? [SFAS 109, par. 41 (ACI27.140)]	_____	_____	_____
6. Have the following items been offset and presented as a single amount for a particular tax-paying component and within a particular tax-paying jurisdiction:			
a. All current deferred tax liabilities and assets?	_____	_____	_____
b. All noncurrent deferred tax liabilities and assets? [SFAS 109, par. 42 (ACI27.141)]	_____	_____	_____
7. Has the valuation allowance for a particular tax jurisdiction been allocated between current and noncurrent deferred tax assets for that tax jurisdiction on a pro rata basis? [SFAS 109, par. 41 (ACI27.140)]	_____	_____	_____
8. Have the components of the total of all deferred tax assets and valuation allowance recognized in the statement of financial position been disclosed? [SFAS 109, par. 43b-c (ACI27.142b-c)]	_____	_____	_____
9. For computer software to be sold, leased, or otherwise marketed:			
a. Is the amount of unamortized cost disclosed for each balance sheet presented? [SFAS 86, par. 11a (AC Co2.110a)]	_____	_____	_____
b. Is the amount charged to expense for amortization of these costs and for amounts written down to net realizable value disclosed for each income statement presented? [SFAS 86, par. 11b (AC Co2.110b)]	_____	_____	_____
10. For foreclosed assets held for sale: <sup>15</sup>			
a. Are the assets valued and disclosed at the lower of fair value minus estimated costs to sell?	_____	_____	_____

<sup>15</sup> Upon adoption of SFAS 114 and 121, many of the provisions of SOP 92-3 are superseded. The following items are applicable to entities that have not yet adopted SFAS 114 and 121.



	<u>Yes</u>	<u>No</u>	<u>N/A</u>
b. If the fair value of the asset, minus the estimated costs to sell, is less than the cost of the asset, has the deficiency been recognized and disclosed as a valuation allowance?	_____	_____	_____
c. Have changes in the valuation allowance based upon fluctuations in the fair value less disposal costs been charged or credited to income and disclosed, if material? [SOP 92-3, par. 12]	_____	_____	_____
11. Are foreclosed assets held for the production of income reported and accounted for in the same way had they been acquired by other means? [SOP 92-3, par. 15]	_____	_____	_____
12. If foreclosed assets originally classified as held-for-sale are to be held for production of income, has the net effect been reported in income from continuing operations in the period in which the decision to retain the asset was made? [SOP 92-3, par. 16]	_____	_____	_____
13. Is a payment by an S corporation to the IRS to retain its fiscal year for tax purposes classified as an asset (deposit)? [EITF 88-4]	_____	_____	_____
<b>J. Current Liabilities</b>			
1. Do current liabilities include:			
a. Obligations for items that have entered the operating cycle?	_____	_____	_____
b. Collections received in advance of the delivery of goods or performance of services?	_____	_____	_____
c. Debts that arise from operations directly related to the operating cycle?	_____	_____	_____
d. Other liabilities whose regular and ordinary liquidation is expected to occur within a relatively short time period?	_____	_____	_____
e. Obligations that, by their terms, are due on demand or will be due within one year (or operating cycle, if longer) from the balance sheet date, even though liquidation may not be expected within that period? [ARB 43, Ch. 3A, pars. 7-8 (AC B05.108-.109); SFAS 78, par. 5 (AC B05.109A and .118)]	_____	_____	_____





	<u>Yes</u>	<u>No</u>	<u>N/A</u>
2. Do current liabilities exclude short-term obligations that the entity intends to refinance on a long-term basis, provided the entity has demonstrated the ability to consummate the long-term financing? [SFAS 6, pars. 8-14 (AC B05.112-.116)]	_____	_____	_____
<b>K. Notes Payable and Other Debt</b>			
1. Is there adequate disclosure of interest rates, maturities, and other terms and conditions provided in loan agreements and bond indentures, such as assets pledged as collateral, covenants to reduce debt, maintain working capital, and restrict dividends? [FASCON 5, par. 11; SFAS 5, par. 18 (AC C59.120)]	_____	_____	_____
2. Are the combined aggregate amount of maturities and sinking fund requirements for all long-term borrowings disclosed for each of the five years following the date of the latest balance sheet presented? [SFAS 47, par. 10b (AC C32.105b)]	_____	_____	_____
3. If a note is noninterest bearing or has an inappropriate stated interest rate:			
a. Is the discount or premium presented as a deduction from or addition to the face amount of the note?	_____	_____	_____
b. Are the effective interest rate and face amount of the note disclosed?	_____	_____	_____
c. Is amortization of the discount or premium reported as interest in the income statement?	_____	_____	_____
d. Are issue costs reported in the balance sheet as deferred charges? [APB 21, par. 16 (AC I69.109)]	_____	_____	_____
4. Are conversion features appropriately accounted for and disclosed? [APB 14, pars. 12 & 16-18 (AC D10.103 and .105-.107)]	_____	_____	_____
5. Are current portions of debt obligations presented as current liabilities? [ARB 43, Ch. 3A, pars. 7-8 (AC B05.108-.109)]	_____	_____	_____
6. If a short-term obligation is to be excluded from current liabilities per SFAS 6, do disclosures include:			
a. General description of the financing agreement?	_____	_____	_____



	<u>Yes</u>	<u>No</u>	<u>N/A</u>
b. Terms of any new obligation incurred or expected to be incurred, or equity securities issued or expected to be issued as a result of the refinancing? [SFAS 6, par. 15 (AC B05.118)]	_____	_____	_____
7. For a troubled debt restructuring occurring during the current period, do disclosures include:			
a. Description of the principal changes in terms, the major features of settlement, or both?	_____	_____	_____
b. Aggregate gain on restructuring of payables and the related income tax effect?	_____	_____	_____
c. Aggregate net gain or loss on transfers of assets recognized during the period?	_____	_____	_____
d. Per share amount of the aggregate gain on restructuring of payables, net of related income tax effect? [SFAS 15, par. 25 (AC D22.121)]	_____	_____	_____
8. For periods after a troubled debt restructuring, do disclosures include:			
a. Extent to which amounts contingently payable are included in the carrying amount of restructured payables?	_____	_____	_____
b. Total amounts contingently payable, if applicable, and conditions under which those amounts would become payable or forgiven? [SFAS 15, par. 26 (AC D22.122)]	_____	_____	_____
9. If there is an extinguishment of debt, is the difference between reacquisition price and carrying amount identified as a separate or extraordinary item? [SFAS 4, par. 8 as amended by SFAS 64, par. 4 (AC D14.105)]	_____	_____	_____
10. If debt is considered to be extinguished, do the disclosures include:			
a. A general description of the transaction?	_____	_____	_____
b. The amount of debt that is considered extinguished as long as the debt remains outstanding? [SFAS 76, par. 6 (AC D14.108)]	_____	_____	_____



	<u>Yes</u>	<u>No</u>	<u>N/A</u>
11. Are long-term obligations that are or will be callable by the creditor either because the debtor's violation 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, classified as current unless one of the following conditions is met?			
a. The creditor has waived or subsequently lost the right to demand repayment for more than one year (or operating cycle, if longer) from the balance-sheet date.	_____	_____	_____
b. The obligation contains a grace period within which the debtor may cure the violation, and it is probable that the violation will be cured within that period, thus preventing the violation from becoming callable. [SFAS 78, par. 5 (AC B05.109A)]	_____	_____	_____
12. If a covenant on a long-term loan agreement is not met and the lender waives its right to call the debt for a period of more than one year, but retains the future covenant requirements, is the debt classified as noncurrent unless:			
a. The covenant violation occurred at the balance-sheet date or would have occurred absent a loan modification?	_____	_____	_____
b. It is probable that the entity will not be able to comply with the covenant within the next 12 months? [EITF 86-30]	_____	_____	_____
13. Has the entity disclosed, either in the body of the financial statements or in the accompanying notes, the following information: [Effective for fiscal years beginning after December 15, 1994, with earlier application encouraged. Previously issued financial statements should not be restated.]			
a. As of the date of each balance sheet presented, has the recorded investment in the loans for which impairment has been recognized, and the total allowance for credit losses related to those impaired loans been disclosed?	_____	_____	_____
b. For each period for which an income statement is presented, has the activity in the allowance for credit losses account, including the balance in the allowance for credit losses account at the beginning and end of each period, additions charged to operations, direct write-downs charged against the allowance, and recoveries of amounts previously charged off been disclosed?	_____	_____	_____





	<u>Yes</u>	<u>No</u>	<u>N/A</u>
<p>c. Has the income recognition policy, dealing with the periodic changes in present value of impaired loans been disclosed? An entity that recognizes income in accordance with this policy also should disclose the amount of interest recognized in accordance with the policy. [SFAS 114, par. 20 (AC I08.118)]</p>	—	—	—
L. Lessee Leases			
1. For capital leases, do disclosures include:			
<p>a. Gross amounts of assets recorded by major class as of the date of each balance sheet presented? [SFAS 13, pars. 13 and 16 (AC L10.112a(1)-(5))]</p>	—	—	—
<p>b. Future minimum lease payments as of the latest balance sheet presented in the aggregate and for each of the five succeeding fiscal years with appropriate separate deductions for executory costs and imputed interest to reduce net minimum lease payments to present value? [SFAS 13, pars. 10 &amp; 16a (AC L10.106 and .112a(2))]</p>	—	—	—
<p>c. Total of future minimum sublease rentals under noncancelable subleases as of the date of the latest balance sheet presented? [SFAS 13, par. 16a (AC L10.112a(3))]</p>	—	—	—
<p>d. Total contingent rentals actually incurred for each period for which an income statement is presented? [SFAS 13, par. 16a (AC L10.112a(4))]</p>	—	—	—
<p>e. Assets recorded under capital leases and the related accumulated amortization and obligations under the lease? [SFAS 13, par. 13 (AC L10.112a(5))]</p>	—	—	—
2. For operating leases that have initial or remaining noncancelable lease terms in excess of one year, do disclosures include:			
<p>a. Future minimum rental payments required as of the latest balance sheet presented in the aggregate and for each of the five succeeding fiscal years?</p>	—	—	—
<p>b. Total of future minimum rentals under noncancelable subleases as of the date of the latest balance sheet presented? [SFAS 13, par. 16b (AC L10.112b)]</p>	—	—	—



	<u>Yes</u>	<u>No</u>	<u>N/A</u>
3. For all operating leases, do disclosures include rental expense for each period for which an income statement is presented with separate amounts for minimum rentals, contingent rentals, and sublease rentals? [SFAS 13, par. 16c (AC L10.112c)]	_____	_____	_____
4. Do disclosures include a general description of the lessee's leasing arrangements including but not limited to:			
a. Bases for determining contingent rentals?	_____	_____	_____
b. Terms of any renewal or purchase options or escalation clauses?	_____	_____	_____
c. Restrictive covenants? [SFAS 13, par. 16d (AC L10.112d)]	_____	_____	_____
<b>M. Other Liabilities and Deferred Credits</b>			
1. Are deferred tax liabilities determined for each tax-paying component (an individual entity or group of entities that is consolidated for tax purposes) in each tax jurisdiction presented separately? [SFAS 109, par. 17 (AC I27.116)]	_____	_____	_____
2. Are deferred tax liabilities classified as current or noncurrent based on the related asset or liability for financial reporting? [SFAS 109, par. 41 (AC I27.140)]	_____	_____	_____
3. Are deferred tax liabilities not related to an asset or liability for financial reporting classified according to the expected reversal date of the temporary difference pursuant to SFAS 109 [AC I27]? [SFAS 109, par. 41 (AC I27.140)]	_____	_____	_____
4. Have the following items been offset and presented as a single amount for a particular tax paying component and within a particular tax-paying jurisdiction:			
a. All current deferred tax liabilities and assets?	_____	_____	_____
b. All noncurrent deferred tax liabilities and assets? [SFAS 109, par. 42 (AC I27.141)]	_____	_____	_____
5. Are the components of the total of all deferred tax liabilities disclosed? [SFAS 109, par. 43a (AC I27.142a)]	_____	_____	_____



	<u>Yes</u>	<u>No</u>	<u>N/A</u>
<b>N. Shareholders' Equity</b>			
1. For each class of stock, do disclosures include the number of shares authorized, issued and outstanding, and par or stated value per share? [APB12, par. 12 (AC C08.102)]	_____	_____	_____
2. Do the financial statements include a description, in summary form, sufficient to explain the pertinent rights and privileges of the various securities outstanding, for example dividend and liquidation preferences, participation rights, call prices and dates, conversion or exercise prices or rates and pertinent dates, sinking fund requirements, unusual voting rights? [APB 15, par. 19 (AC E09.110)]	_____	_____	_____
3. Are liquidation preferences of preferred stock issues prominently disclosed in the equity section of the balance sheet in the aggregate? [APB 10, par. 10 (AC C16.101)]	_____	_____	_____
4. For preferred stock, do disclosures include:			
a. Aggregate or per share amounts at which shares may be called or are subject to redemption? [APB 10, par. 11 (AC C16.102)]	_____	_____	_____
b. Aggregate and per share amounts of arrearages in cumulative preferred dividends? [APB 15, par. 50, footnote 16 (AC C16.102)]	_____	_____	_____
5. For stock option and stock purchase plans, do disclosures include:			
a. Number of shares under option?	_____	_____	_____
b. Option price?	_____	_____	_____
c. Number of shares as to which options are exercisable?	_____	_____	_____
d. For options exercised, the number of shares exercised and option price? [ARB 43, Ch. 13B, par. 15 (AC C47.123)]	_____	_____	_____
6. Are any appropriations of retained earnings for loss contingencies clearly identified and included in shareholders' equity? [SFAS 5, par. 15 (AC R70.103)]	_____	_____	_____
7. Are restrictions on payment of dividends disclosed? [SFAS 5, pars. 18-19 (AC C59.120)]	_____	_____	_____



	<u>Yes</u>	<u>No</u>	<u>N/A</u>
8. After completion of a quasi-reorganization, is a new retained earnings account established and dated with the date being disclosed in subsequent financial statements until it is no longer deemed significant? [ARB 43, Ch. 7A, par. 10 (AC Q15.111); ARB 46 (AC Q15.111)]	_____	_____	_____
9. Are the amounts of redemption requirements for all issues of capital stock that are redeemable at fixed or determinable prices on fixed or determinable dates disclosed for each of the five years following the date of the latest balance sheet presented? [SFAS 47, par. 10c (AC C32.105c)]	_____	_____	_____
10. Are the carrying basis, cost, and number of shares disclosed for treasury stock? [APB 6, par. 12b (AC C32.103)]	_____	_____	_____
<b>O. Changes in Shareholders' Equity</b>			
1. Are changes in the separate component accounts of shareholders' equity disclosed? [APB 12, par. 10 (AC C08.102)]	_____	_____	_____
2. Are changes in the number of shares of equity securities disclosed? [APB 12, par. 10 (AC C08.102)]	_____	_____	_____
3. Are prior period adjustments and their resulting effects (both gross and net of applicable income taxes) appropriately disclosed? [APB 9, par. 26 (AC A35.107)]	_____	_____	_____
4. If an additional liability required to be recognized pursuant to SFAS 87, paragraph 36 [AC P16.130], exceeds unrecognized prior service cost, has the excess (which would represent a net loss not yet recognized as net periodic pension cost) been reported as a separate component (that is, a reduction) of equity, net of any tax benefits that result from considering such losses as timing differences for purposes of applying the provisions of SFAS 87, par. 37, ACI 27, SFAS 109, par. 287? [SFAS 87, par. 37 (AC P16.131)]	_____	_____	_____

**Income Statement**

**A. Revenue and Expenses**

1. Are the important components of income separately disclosed, such as sales or other sources of revenue, cost of sales, selling and administrative expenses, interest expense and income taxes? [Generally Accepted]	_____	_____	_____
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	<u>Yes</u>	<u>No</u>	<u>N/A</u>
2. For long-term construction-type contracts, is the method of income recognition (percentage-of-completion or completed-contract) disclosed? [ARB 45, par. 15 (AC C04.112); APB 22, par. 13 (AC A10.106)]	_____	_____	_____
3. For each period for which an income statement is presented, are the following disclosed:			
a. The proceeds from sales of available-for-sale securities and gross realized gains and losses from those sales?	_____	_____	_____
b. The basis on which cost was determined in computing realized gain or loss, i.e., specific identification, average cost, or other method used?	_____	_____	_____
c. The gross gains and losses included in earnings from transfers of securities from the available-for-sale category to the trading category?	_____	_____	_____
d. The change in net unrealized holding gain or loss on available-for-sale securities that has been included in the separate component of shareholders' equity?	_____	_____	_____
e. The change in net unrealized holding gain or loss on trading securities that has been included in earnings? [SFAS 115, par. 21 (AC I80.120)]	_____	_____	_____
4. For any sales of or transfers from securities classified as held-to-maturity, are the following disclosed for each period for which an income statement is presented:			
a. Amortized cost of the sold or transferred security?	_____	_____	_____
b. Related realized or unrealized gain or loss?	_____	_____	_____
c. The circumstances leading to the decision to sell or transfer the security? [SFAS 115, par. 22 (AC I80.121)]	_____	_____	_____
5. Are research and development costs charged to expense when incurred and appropriately disclosed? [SFAS 2, pars. 12-13 (AC R50.108-.109)]	_____	_____	_____
6. Is the amount of interest cost incurred disclosed in the statements or notes thereto, and for an accounting period in which some interest cost is capitalized, the amount that has been capitalized? [SFAS 34, par. 21 (AC I67.118)]	_____	_____	_____







	<u>Yes</u>	<u>No</u>	<u>N/A</u>
7. If the entity accounts for its obligation under a research and development arrangement as a contract to perform research and development for others under SFAS 68, is there disclosure of:			
a. The terms of significant agreements under the research and development arrangement as of the date of each balance sheet presented?	_____	_____	_____
b. The amount of compensation earned or costs incurred under such contracts for each period for which an income statement is presented? [SFAS 68, par. 14 (AC R55.112)]	_____	_____	_____
8. Do disclosures for advertising costs include:			
a. The accounting policy selected from the two alternatives in the beginning of paragraph 26 of SOP 93-7 for reporting advertising, indicating whether such costs are expensed as incurred or the first time the advertising takes place?	_____	_____	_____
b. A description of the direct-response advertising reported as assets (if any), the accounting policy for it, and the amortization period?	_____	_____	_____
c. The total amount charged to advertising expense for each income statement presented, with separate disclosure of amounts, if any, representing a write-down to net realizable value?	_____	_____	_____
d. The total amount of advertising reported as assets in each balance sheet presented? [SOP 93-7, par. 49]	_____	_____	_____
<b>B. Income Taxes</b>			
1. Are the types of significant temporary differences and carryforwards disclosed? [SFAS 109, par. 43 (AC I27.142)]	_____	_____	_____
2. Are the following significant components of income tax expense attributable to continuing operations for each year presented disclosed in the financial statements or notes thereto?			
a. Current tax expense or benefit.	_____	_____	_____
b. Deferred tax expense or benefit (exclusive of the effects of other components listed below).	_____	_____	_____





	<u>Yes</u>	<u>No</u>	<u>N/A</u>
c. Investment tax credits.	_____	_____	_____
d. Government grants (to the extent recognized as a reduction of income tax expense).	_____	_____	_____
e. The benefits of operating loss carryforwards.	_____	_____	_____
f. Tax expense that results from allocating certain benefits either directly to contributed capital or to reduce goodwill or other noncurrent intangible assets of an acquired entity.	_____	_____	_____
g. Adjustments of a deferred tax liability or asset for enacted changes in tax laws or rates or a change in the tax status of the enterprise.	_____	_____	_____
h. Adjustments of the beginning-of-the-year balance of a valuation allowance because of a change in circumstances that causes a change in judgment about the realizability of the related deferred tax asset in future years. [SFAS 109, par. 45a-h (AC I27.144a-h)]	_____	_____	_____
3. Are the amount of income tax expense or benefit allocated to continuing operations and the amounts separately allocated to other items (in accordance with paragraphs 35-39 of SFAS 109 [AC I27.134-.138]) disclosed for each year for which those items are presented? [SFAS 109, par. 46 (AC I27.145)]	_____	_____	_____
4. Is the nature of significant reconciling items resulting from the reported amount of income tax expense attributable to continuing operations for the year compared to the amount of income tax expense that would result from applying domestic statutory tax rates to pretax income from continuing operations disclosed? [SFAS 109, par. 47 (AC I27.146)]	_____	_____	_____
5. Are the amounts and expiration dates of operating loss and tax credit carryforwards for tax purposes disclosed? [SFAS 109, par. 48 (AC I27.147)]	_____	_____	_____
6. If the entity is a member of a group that files a consolidated tax return, have the following items been disclosed in its separately issued financial statements:			
a. The aggregate amount of current and deferred tax expense for each income statement presented and the amount of any tax-related balances due to or from affiliates as of the date of each statement of financial position presented?	_____	_____	_____



	<u>Yes</u>	<u>No</u>	<u>N/A</u>
<p>b. The principal provisions of the method by which the consolidated amount of current and deferred tax expense is allocated to members of the group and the nature and effect of any changes in that method (and in determining related balances to or from affiliates) during the years for which the disclosures in Step 6.a above are presented? [SFAS 109, par. 49 a-b (AC I27.148 a-b)]</p>	_____	_____	_____
<b>C. Discontinued Operations</b>			
<p>1. Are operations of a segment that has been discontinued or is the subject of a formal plan for disposition:</p> <p>a. Reported separately from income from continuing operations and as a component (including applicable income taxes) of income before extraordinary items?</p> <p>b. Accompanied by disclosure in the notes of revenue applicable to the discontinued operations? [APB 30, pars. 8 &amp; 13-18 (AC I13.101-.103, .105-.106 and .108-.109)]</p>	_____	_____	_____
<p>2. Is gain or loss from disposal of a discontinued segment reported separately (including applicable income taxes) in conjunction with results of discontinued operations as a component of income before extraordinary items. [APB 30, pars. 8, 13 &amp; 18 (AC I13.101-.103, .105-.106 and .108-.109)]</p>	_____	_____	_____
<p>3. For the period encompassing the measurement date, do notes to financial statements disclose:</p> <p>a. Identity of the segment discontinued?</p> <p>b. Expected disposal date, if known?</p> <p>c. Expected manner of disposal?</p> <p>d. Description of the remaining assets and liabilities of the discontinued segment at the balance sheet date?</p> <p>e. Income or loss from operations and any proceeds from disposal of the discontinued segment during the period from the measurement date to the balance sheet date?</p>	_____	_____	_____





	<u>Yes</u>	<u>No</u>	<u>N/A</u>
f. The fact that the loss on disposal cannot be determined within reasonable limits, if applicable? [APB 30, par. 18, footnote 7 (AC I13.108-.109)]	_____	_____	_____
4. For periods after the measurement date and including the disposal, do notes to financial statements disclose the information required for the period encompassing the measurement date and the actual date and results of disposal compared with the prior estimates? [APB 30, par. 18 (AC I13.108-.109)]	_____	_____	_____
5. If an entity has accounted for the discontinuance of a segment in accordance with APB 30 and subsequently decides to retain the segment, is any impairment write down of the individual assets classified in continuing operations? [EITF 90-16]	_____	_____	_____
6. If the entity plans to dispose of two segments of a business and a net gain is expected (one has a net gain and the other a net loss) is that gain shown net? [EITF 85-35]	_____	_____	_____
<b>D. Extraordinary Items</b>			
1. Are extraordinary items segregated and shown (including applicable income taxes) following income before extraordinary items and before net income? [APB 30, par. 11 (AC I17.102)]	_____	_____	_____
2. Are descriptive captions and amounts (including applicable income taxes) presented for individual extraordinary events or transactions, preferably on the face of the income statement if practicable? [APB 30, par. 11 (AC I17.102)]	_____	_____	_____
3. Do disclosures include descriptions of an extraordinary event(s) or transaction(s) and the principal items entering into determination of extraordinary gain(s) or loss(es)? [APB 30, par. 11 (AC I17.102)]	_____	_____	_____
4. Are material events or transactions that are either unusual in nature, or of infrequent occurrence but not both (and therefore not meeting criteria for extraordinary items):			
a. Reported as a separate component of income from continuing operations?	_____	_____	_____





	<u>Yes</u>	<u>No</u>	<u>N/A</u>
b. Accompanied by disclosure of the nature and financial effects of each event? [APB 30, par. 26 (AC I22.101)]	_____	_____	_____
5. For gains or losses from extinguishment of debt classified as extraordinary items, do disclosures include:			
a. Description of the extinguishment transactions, including the sources of any funds used to extinguish the debt if it is practicable to identify the sources?	_____	_____	_____
b. Income tax effect in the period of extinguishment?	_____	_____	_____
c. Per share amount of the aggregate gain or loss net of related income tax effect? [SFAS 4, par. 9 (AC I17.104)]	_____	_____	_____
6. For an adjustment of an extraordinary item reported in a prior period:			
a. Is the adjustment classified separately as an extraordinary item in the current period	_____	_____	_____
b. Are the nature, origin, and amount of the item disclosed? [SFAS 16, par. 16(c) (AC I17.119)]	_____	_____	_____
7. For nonpublic companies, if there is a restructuring charge, is it reflected using the most meaningful income statement presentations, within the framework of APB 30? [EITF 87-4 and 94-3]	_____	_____	_____
E. Other			
1. Are the following excluded from determination of net income or results of operations under all circumstances:			
a. Adjustments, charges, or credits resulting from transactions in the company's own capital stock?	_____	_____	_____
b. Transfers to and from accounts properly designated as appropriated retained earnings?	_____	_____	_____
c. Adjustments made pursuant to a quasi-reorganization? [APB 9, par. 28 (AC C08.101)]	_____	_____	_____





- |   | <u>Yes</u> | <u>No</u> | <u>N/A</u> |
|---|------------|-----------|------------|
| 2. Is earnings per share information, if required [SFAS 21 (AC E09.102)], presented on the face of the income statement accompanied by appropriate disclosure that includes the basis of the calculation? [APB 15 (AC E09)] | _____      | _____     | _____      |

### Statement of Cash Flows

- |  |       |       |       |
|--|-------|-------|-------|
| 1. Is a statement of cash flows presented as a basic financial statement for each period for which a statement of income is presented? [SFAS 95, par. 3 (AC C25.101)]  | _____ | _____ | _____ |
| 2. Do the notes disclose the entity's accounting policy for determining which items are treated as cash equivalents? [SFAS 95, par. 10 (AC C25.108)]   | _____ | _____ | _____ |
| 3. Does the statement of cash flows from operating activities separately report:   |       |       |       |
| a. Cash received from customers?   | _____ | _____ | _____ |
| b. Interest and dividends received?  | _____ | _____ | _____ |
| c. Other operating cash receipts (if any)?   | _____ | _____ | _____ |
| d. Cash paid to employees and suppliers?   | _____ | _____ | _____ |
| e. Interest paid?  | _____ | _____ | _____ |
| f. Income taxes and other payments to government?  | _____ | _____ | _____ |
| g. Other operating cash payments (if any)? [SFAS 95, par. 27 (AC C25.125)]   | _____ | _____ | _____ |
| 4. If the direct method is used, is a separate reconciling schedule provided to reconcile Net Income to Net Cash Used or Provided by Operating Activities? [SFAS 95, par. 29 (AC C25.127)]                     | _____ | _____ | _____ |
| 5. Have investing and financing activities that affect recognized assets or liabilities but that do not result in cash receipts or cash payments in the period been disclosed? [SFAS 95, par. 32 (AC C25.134)] | _____ | _____ | _____ |



	<u>Yes</u>	<u>No</u>	<u>N/A</u>
6. If the indirect method is used:			
a. Is the same amount for net cash flow from operating activities reported indirectly by adjusting the excess of revenues and expenses (income) to reconcile it to net cash flow from operating activities? [SFAS 95, par. 28 (AC C25.126)]	_____	_____	_____
b. Is the reconciliation of the excess of revenues and expenses (income) to net cash flow from operating activities reported, either within the statement of cash flows or provided in a separate schedule, with the statement of cash flows reporting only the net cash flow from operating activities? [SFAS 95, par. 30 (AC C25.128)]	_____	_____	_____
7. Are cash receipts and cash payments for the following transactions classified as cash flows from investing activities:			
a. Receipts from collections or sales of loans?	_____	_____	_____
b. Receipts from sales of property, plant and equipment?	_____	_____	_____
c. Loans to others?	_____	_____	_____
d. Payments to acquire property, plant and equipment?	_____	_____	_____
e. Receipts from sales of equity instruments of other enterprises exclusive of those carried in the trading account?	_____	_____	_____
f. Payments to acquire equity instruments of other enterprises, exclusive of those carried in the trading account? [SFAS 95, pars. 16-17 (AC C25.114-.115)]	_____	_____	_____
8. Are cash receipts and cash payments for the following transactions classified as cash flows from financing activities:			
a. Proceeds from issuing debt?	_____	_____	_____
b. Issuance of equity instruments?	_____	_____	_____
c. Payment of dividends?	_____	_____	_____
d. Repayments for amounts borrowed?	_____	_____	_____
e. Purchases of treasury stock?	_____	_____	_____





	<u>Yes</u>	<u>No</u>	<u>N/A</u>
f. Other principal payments to creditors who have extended long-term debt? [SFAS 95, pars. 19-20 (AC C25.117-.118)]	_____	_____	_____
9. Except for certain items whose turnover is quick, amounts are large and maturities are short, are cash receipts and cash payments from investing and financing activities shown separately on the statement of cash flows? [SFAS 95, pars. 12-13 and 31 (AC C25.110-.111 and .129)]	_____	_____	_____

**Exhibit A - Postretirement Health Care Benefits:** The effective date of SFAS 106 is for fiscal years beginning after December 15, 1992 except for plans outside the United States and for defined benefit plans of employers that (a) are nonpublic entities and (b) sponsor defined benefit postretirement plan(s) with no more than 500 plan participants in the aggregate in which case the effective date is for fiscal years beginning after December 15, 1994. Earlier application is encouraged. Until such time the following disclosures remain in effect:

A. Postretirement Health Care and Life Insurance Benefits

1. If health care or life insurance benefits are provided to retirees, their dependents, or survivors, do disclosures<sup>16</sup> include:
  - (a) A description of the benefits provided and the employee groups covered? \_\_\_\_\_
  - (b) A description of accounting and funding policies followed for those benefits? \_\_\_\_\_
  - (c) The cost<sup>17, 18</sup> of those benefits recognized for the period, unless the provisions of Step 2 below are applicable? \_\_\_\_\_

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<sup>16</sup> SFAS 81 [AC P50] does not preclude additional disclosures. The FASB is aware that a few employers currently disclose information other than that required by SFAS 81, such as the present value of estimated future health care and life insurance benefits for retirees, the amount of contributions to trusts established for the payment of those benefits, and the fair value of assets in such trusts. The FASB encourages such disclosures but does not require that they be made. Paragraph 28 of SFAS 81 [AC P50.102, footnote 2] also identifies additional information that an employer is encouraged to disclose.

<sup>17</sup> The cost disclosed should be based on the accounting policy described.-

<sup>18</sup> Employers are encouraged to use reasonable methods to approximate the costs of postretirement health care and life insurance benefits. The disclosures may be made separately for each type of benefit provided or in the aggregate for all benefits.





	<u>Yes</u>	<u>No</u>	<u>N/A</u>
(d) The effect of significant matters affecting the comparability of the costs recognized for all periods presented? [SFAS 81, par. 6 (AC P50.102)]	_____	_____	_____
2. If the cost of any postretirement health care or life insurance benefit cannot readily be separated from the cost of providing such benefits for active employees or otherwise be reasonably approximated, is the total cost of providing those benefits to both active employees and retirees as well as the number of active employees and the number of retirees covered by the plan disclosed? [SFAS 81, par. 7 (AC P50.103)]	_____	_____	_____

**Exhibit B - Impairment Of Loans Receivable**

The following disclosures should be considered by entities that have not yet adopted SFAS 114, which is effective for fiscal years beginning after December 15, 1994. Until SFAS 114 is adopted, the following disclosures remain in effect:

**A. Impairment of Loans Receivable**

1. For receivable involved in troubled debt restructurings, are the following disclosed, by major category of loans, as of the date of each balance sheet presented:			
a. Aggregate recorded investment?	_____	_____	_____
b. Gross interest income that would have been recorded if loans had been current per their original terms and had been outstanding throughout the period or since origination?	_____	_____	_____
c. Amount of interest income included in net income?	_____	_____	_____
d. Amounts of any commitment to lend additional funds to debtors owing restructured troubled loans? [SFAS 15, pars. 40-41 (AC D22.136-.137)]	_____	_____	_____





### Specialized Industries

The following FASB Statements and Interpretations relate in whole or in part to specialized industries. To the extent they relate to specialized industries, they are not included in these Disclosure Checklists. Users of the checklists should refer directly to applicable authoritative pronouncements when reporting on a specialized industry.

#### FASB Statements Related to Specialized Accounting and Reporting Principles and Practices

- SFAS 19 "Financial Accounting and Reporting by Oil and Gas Producing Companies"
- SFAS 25 "Suspension of Certain Accounting Requirements for Oil and Gas Producing Companies"
- SFAS 35 "Accounting and Reporting by Defined Benefit Pension Plans"
- SFAS 44 "Accounting for Intangible Assets of Motor Carriers"
- SFAS 45 "Accounting for Franchise Fee Revenue"
- SFAS 50 "Financial Reporting in the Record and Music Industry"
- SFAS 51 "Financial Reporting by Cable Television Companies"
- SFAS 53 "Financial Reporting by Producers and Distributors of Motion Picture Films"
- SFAS 60 "Accounting and Reporting by Insurance Enterprises"
- SFAS 61 "Accounting for Title Plant"
- SFAS 63 "Financial Reporting by Broadcasters"
- SFAS 65 "Accounting for Certain Mortgage Banking Activities"
- SFAS 66 "Accounting for Sales of Real Estate"
- SFAS 67 "Accounting for Costs and Initial Rental Operations of Real Estate Projects"
- SFAS 69 "Disclosures about Oil and Gas Producing Activities"
- SFAS 71 "Accounting for the Effects of Certain Types of Regulation"
- SFAS 72 "Accounting for Certain Acquisitions of Banking or Thrift Institutions"
- SFAS 73 "Reporting a Change in Accounting for Railroad Track Structures"
- SFAS 86 "Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed"

- ◆
- SFAS 90 "Regulated Enterprises — Accounting for Abandonments and Disallowances of Plant Costs"
- SFAS 92 "Regulated Enterprises — Accounting for Phase-in Plans"
- SFAS 93 "Recognition of Depreciation by Not-for-Profit Organizations"
- SFAS 97 "Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments"
- SFAS 101 "Regulated Enterprises — Accounting for the Discontinuation of Application of FASB Statement No. 71"
- SFAS 102 "Statement of Cash Flows — Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale"
- SFAS 104 "Statement of Cash Flows — Net Reporting of Certain Cash Receipts and Cash Payments and Classifications of Cash Flows from Hedging Transactions"
- SFAS 110 "Reporting by Defined Benefit Pension Plans of Investment Contracts"
- SFAS 113 "Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts"
- SFAS 117 "Financial Statements of Not-for-Profit Organizations"
- SFAS 120 "Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts"
- SFAS 122 "Accounting for Mortgage Servicing Rights"
- FASB Interpretations Related to Industries Having Specialized Accounting and Reporting Principles and Practices
- Interpretation 9 "Applying APB Opinion Nos. 16 and 17, When a Savings and Loan Association or a Similar Institution Is Acquired in a Business Combination Accounted for by the Purchase Method: An Interpretation of APB Opinion Nos. 16 and 17"
- Interpretation 33 "Applying FASB Statement No. 34 to Oil and Gas Producing Operations Accounted for by the Full Cost Method: An Interpretation of FASB Statement No. 34"
- Interpretation 36 "Accounting for Exploratory Wells in Progress at the End of a Period: An Interpretation of FASB Statement No. 19"
- Interpretation 40 "Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises"
- Interpretation 41 "Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements"



**18.300 AUDITORS' REPORTS CHECKLIST**

Explanation of References:

- SAS = Statement of Auditing Standards
- SSARS = AICPA Statement on Standards for Accounting and Review Services
- AU = Reference to section number in AICPA Professional Standards (vol. 1) of SAS cited
- AR = Reference to section number in AICPA Professional Standards (vol. 2)

**CHECKLIST QUESTIONNAIRE**

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
1. Does the auditor's report include appropriate:			
a. Addressee? [SAS 58, par. 9 (AU 508.09)]	_____	_____	_____
b. Date (or dual dates) of the report? [SAS 1, sec. 530.05 (AU 530.05)]	_____	_____	_____
c. A title that includes the word "independent"? [SAS 58, par. 8a (AU 508.08a)]	_____	_____	_____
2. If the accountant is not independent, is a compilation report indicating the lack of independence issued (non-public companies only)? [SAS 26, par. 10 (AU 504.10); SSARS 1, pars. 22 and 38 (AR 100.22 and .38)]	_____	_____	_____
3. Does the reporting language conform with the auditor's standard report on:			
a. Financial statements of a single year or period?	_____	_____	_____
b. Comparative financial statements? [SAS 58, par. 8 (AU 508.08)]	_____	_____	_____
4. Does the report include appropriate language for the following situations:			
a. Only one basic financial statement is presented and there are no scope limitations? [SAS 58, pars. 47-48 (AU 508.47-.48)]	_____	_____	_____
b. Audited and unaudited financial statements are presented in comparative form? [SAS 26, pars. 14-17 (AU 504.14-.17)]	_____	_____	_____



	<u>Yes</u>	<u>No</u>	<u>N/A</u>
5. Is an explanatory paragraph (or other explanatory language) added to the standard report if:			
a. The financial statements 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? [SAS 58, pars. 16–33 (AU 508.16–.33)]	_____	_____	_____
<p><b>Note:</b> Consult the Topical Index to the AICPA <i>Professional Standards</i> under "Uncertainties" for additional references to specific types of uncertainties.</p>			
b. There is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time and that conclusion is expressed through the use of the phrase "substantial doubt about its (the entity's) ability to continue as a going concern"? [SAS 64, par. 1 (AU 341.12–.13)]	_____	_____	_____
c. There is a material change between periods in accounting principles or in the method of their application? [SAS 58, pars. 34–36 (AU 508.34–.36)]	_____	_____	_____
d. In an updated report on comparative financial statements, the current opinion on the prior period is different from the one previously expressed? [SAS 58, pars. 77–78 and 81–82 (AU 508.77–.78 and .81–.82)]	_____	_____	_____
e. The prior period financial statements are audited by a predecessor auditor whose report is not presented? [SAS 64, par. 2 (AU 508.83)]	_____	_____	_____
f. The auditor's opinion is based in part on the report of another auditor? [SAS 1, sec. 543 (AU 543); SAS 58, pars. .12–.13 (AU 508.12–.13)]	_____	_____	_____
g. The financial statements contain a departure from a promulgated accounting principle when conformity with GAAP would result in a misleading presentation? [SAS 58, pars. 14–15 (AU 508.14–.15)]	_____	_____	_____
h. Other information in a document containing audited financial statements is materially inconsistent with information appearing in the financial statements? [SAS 8, par. 4 (AU 550.04)]	_____	_____	_____





	<u>Yes</u>	<u>No</u>	<u>N/A</u>
i. The auditor decides to emphasize a matter in the report? [SAS 58, pars. 37 (AU 508.37); Interpretation 38 of SAS 1, sec. 410 (AU 9410.17); Interpretation 1 of SAS 57 (AU 9342.03)]	_____	_____	_____
6. Is a qualified opinion or disclaimer of opinion expressed if scope limitations preclude application of one or more auditing procedures considered necessary in the circumstances? [SAS 58, pars. 40–45 (AU 508.40-.45); SAS 31, par. 23 (AU 326.23); SAS 19, par. 12 (AU 333.12)]	_____	_____	_____
<p><b>Note:</b> Consult the Topical Index to the AICPA <i>Professional Standards</i> under "Scope of Audit — Limitations" for additional references to specific types of scope limitations that could result in either a qualified or disclaimer of opinion.</p>			
7. Is a qualified opinion or adverse opinion expressed if a lack of conformity with GAAP (including inadequate disclosure) is present? [SAS 58, pars. 49–66 (AU 508.49-.66); SAS 32, par. 3 (AU 431.03)]	_____	_____	_____
<p><b>Note:</b> Consult the Topical Index to the AICPA <i>Professional Standards</i> under "Departures from Established Principles," "Adverse Opinions," and "Qualified Opinions" for additional references to specific types of GAAP departures that could result in either a qualified or adverse opinion.</p>			
8. Is a qualified or adverse opinion expressed if the entity specifically requests the auditor to report on prior-period financial statements that are incomplete (e.g., prior-period totals only)? [SAS 58, fn. 27 (AU 508, fn. 27)]	_____	_____	_____
9. If a qualified opinion, adverse opinion, or disclaimer of opinion is expressed, are all the substantive reasons for the opinion or disclaimer disclosed and is the reporting language appropriately modified? [SAS 58, pars. 39, 68–69, and 71 (AU 508.39, .68-.69, and .71)]	_____	_____	_____
10. If information accompanies the basic financial statements and auditor's report in an auditor-submitted document, does the report on the accompanying information:			
a. State that the audit is performed for the purpose of forming an opinion on the basic financial statements taken as a whole?	_____	_____	_____
b. Specifically identify the accompanying information?	_____	_____	_____



	<u>Yes</u>	<u>No</u>	<u>N/A</u>
c. State that the accompanying information is presented for purposes of additional analysis and is not a required part of the basic financial statements?	_____	_____	_____
d. State whether the accompanying information is subject to the auditing procedures applied in the audit of the basic financial statements and the appropriate expression of opinion or disclaimer? [SAS 29, pars. 6-11 (AU 551.06-.11)]	_____	_____	_____
11. Is the reporting form and content of SAS 60, paragraphs 9 through 19, followed when communicating internal control structure related matters noted in an audit? <sup>1</sup> [SAS 60, pars. 9-19 (AU 325.09-.19)]	_____	_____	_____

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<sup>1</sup> Reportable conditions in internal control structure that have not been corrected must be communicated, preferably in writing, to senior management and the board of trustees or its audit committee. [SAS 60]



## 18.400 ACCOUNTANTS' REPORTS ON COMPILED OR REVIEWED FINANCIAL STATEMENTS

Explanation of References:

SSARS = Statement on Standards for Accounting and Review Services

AR = Reference to section number in AICPA Professional Standards (vol. 2) of SSARS cited

This checklist is divided into two parts. Part I should be used by accountants engaged to compile financial statements; Part II should be used by accountants engaged to review financial statements.

### CHECKLIST QUESTIONNAIRE

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
<b>PART I - FOR COMPILE ENGAGEMENTS</b>			
1. Is the compilation report appropriately worded? [SSARS 1, par. 14 (AR 100.14)]	_____	_____	_____
2. Does the report exclude a description of any other procedures that the accountant might have performed before or during the engagement? [SSARS 1, par. 14 (AR 100.14)]	_____	_____	_____
3. For compiled financial statements that contain departures <sup>1</sup> from generally accepted accounting principles (GAAP) or, where applicable, an other comprehensive basis of accounting (OCBOA):			
a. If the departure is the omission of substantially all required disclosures, does the accountant's report clearly indicate such omission? [SSARS 1, pars. 19 and 21 (AR 100.19 and .21)]	_____	_____	_____
b. If compiled financial statements that omit substantially all of the disclosures required by GAAP include disclosures about only a few matters, are such disclosures labeled "Selected Information — Substantially All Disclosures Required by Generally Accepted Accounting Principles (or OCBOA) Are Not Included"? [SSARS 1, par. 19 (AR 100.19)]	_____	_____	_____

<sup>1</sup> Other than departures required by a prescribed form or related instructions when the accountant issues a SSARS 3 [AR 300] compilation report on financial statements included in a prescribed form.





	<u>Yes</u>	<u>No</u>	<u>N/A</u>
c. If statements that omit substantially all required disclosures are prepared on a basis of accounting other than GAAP, and if such statements do not include disclosure of the basis of accounting used, does the accountant's report disclose the basis of accounting? <sup>2</sup> [SSARS 1, par. 20 (AR 100.20)]	_____	_____	_____
d. If the financial statements contain a departure from GAAP or an OCBOA, is the report modified to describe the departure? [SSARS 1, pars. 39 and 40 (AR 100.39 and .40)]	_____	_____	_____
(1) If the effects of the departure on the financial statements have been determined by management or are known as a result of the accountant's procedures, are these effects also disclosed in the modified report? [SSARS 1, par. 40 (AR 100.40)]	_____	_____	_____
(2) If the effects have not been determined, is this fact stated in the accountant's report? [SSARS 1, par. 40 (AR 100.40)]	_____	_____	_____
4. If the accountant is not independent with respect to the entity for which he or she has compiled financial statements, does the compilation report state, "I am (we are) not independent with respect to XYZ Company"? [SSARS 1, pars. 22 and 38 (AR 100.22 and .38)]	_____	_____	_____
5. Is the report properly dated? [SSARS 1, par. 15 (AR 100.15)]	_____	_____	_____
6. Does each page of the financial statements include a reference such as "See Accountant's Compilation Report"? [SSARS 1, par. 16 (AR 100.16)]	_____	_____	_____
7. If the financial statements do not appropriately disclose an uncertainty, including an uncertainty about an entity's ability to continue as a going concern, or an inconsistency in the application of accounting principles, has consideration been given to including a separate paragraph that discloses such matters? [SSARS 1, par. 40, footnote 18 (AR 100.40 fn 18)]	_____	_____	_____

<sup>2</sup> SAS 62, paragraphs 9 and 10 (AU Secs. 623.09-.10) provides guidance on evaluating the adequacy of disclosure in financial statements prepared in conformity with another comprehensive basis of accounting.





	<u>Yes</u>	<u>No</u>	<u>N/A</u>
8. If the accountant has compiled both the basic financial statements and other data that is presented for supplementary analysis purposes, does the compilation report also include the other data, indicating the degree of responsibility taken? [SSARS 1, par. 43 (AR 100.43)]	_____	_____	_____
9. If an audit engagement has been changed to a review or compilation, does the report omit reference to: a) the original engagement, b) any auditing or review procedures that may have been performed, c) any scope limitation that resulted in the changed engagement? [SSARS 1, par. 49 (AR 100.49)]	_____	_____	_____
10. If comparative financial statements are presented, does the accountant's report cover each period presented? [SSARS 2, par. 2 (AR 200.02)]	_____	_____	_____
11. If compiled financial statements that omit substantially all of the disclosures required by GAAP are included among the comparative financial statements, do all the periods presented also omit such disclosures? [SSARS 2, par. 5 (AR 200.05)]	_____	_____	_____
a. If the prior period financial statements did not omit the required disclosures, and the accountant is requested to compile statements for the same period that do omit those disclosures, does the accountant's compilation report include an additional paragraph that indicates:			
1. The nature of the previous service rendered (compilation, review, or audit)?	_____	_____	_____
2. Date of the previous report? [SSARS 2, pars. 29-30 (AR 200 .29-.30)]	_____	_____	_____
12. If the level of service performed by the continuing accountant on the current-period financial statements is the same or higher than that performed on the financial statements of the prior period presented, has the continuing accountant's report on the prior period been updated? [SSARS 2, par. 8 (AR 200.08)]	_____	_____	_____
13. If the level of service performed by the continuing accountant on the current-period financial statements is lower than that performed on the financial statements of the prior period presented, is the report of the current period modified appropriately or combined with a reissued report from the prior period? [SSARS 2, pars. 8, and 11-12 (AR 200.08, and .11-.12)]	_____	_____	_____





	<u>Yes</u>	<u>No</u>	<u>N/A</u>
3. For reviewed financial statements that contain departures from GAAP or, where applicable, OCBOA (including the omission of required disclosures), is the report modified to disclose the departure in a separate paragraph? [SSARS 1, pars. 39 and 40 (AR 100.39 and .40)]	_____	_____	_____
4. If the financial statements do not appropriately disclose an uncertainty, including an uncertainty about an entity's ability to continue as a going concern, or an inconsistency in the application of accounting principles, has consideration been given to including a separate paragraph that discloses such matters? [SSARS 1, par. 40 (AR 100.40 footnote 18)]	_____	_____	_____
5. Is the report properly dated? [SSARS 1, par. 33 (par. 100.33)]	_____	_____	_____
6. Does each page of the financial statements reviewed by the accountant include a reference such as "See Accountant's Review Report"? [SSARS 1, par. 34 (AR 100.34)]	_____	_____	_____
7. When accompanying information is presented with the financial statements, does the report clearly indicate degree of responsibility the accountant has taken with respect to such information? [SSARS 1, par. 43 (AR 100.43)]	_____	_____	_____
8. Was a representation letter obtained from the client to confirm the oral representations made to the accountant?	_____	_____	_____
a. If the client did not provide a representation letter, did the accountant consider the matters discussed in paragraphs 44-49 of SSARS 1 in deciding whether it is appropriate to issue a compilation report?	_____	_____	_____
9. If an audit engagement has been changed to a review, does the report omit reference to: a) the original engagement, b) any auditing or review procedures that may have been performed, c) any scope limitation that resulted in the changed engagement? [SSARS 1, par. 49 (AR 100.49)]	_____	_____	_____
10. If comparative financial statements are presented, does the accountant's report cover each period presented? [SSARS 2, par. 2 (AR 200.02)]	_____	_____	_____



	<u>Yes</u>	<u>No</u>	<u>N/A</u>
11. If the level of service performed by the continuing accountant on the current-period financial statements is the same or higher than that performed on the financial statements of the prior period presented, has the continuing accountant's report on the prior period been updated? [SSARS 2, pars. 8-10 (AR 200.08-.10)]	_____	_____	_____
12. If the level of service performed by the continuing accountant on the current-period financial statements is lower than that performed on the financial statements of the prior period presented, is the report of the current period modified appropriately or combined with a reissued report from the prior period? [SSARS 2, pars. 8 and 11-12 (AR 200.08, and .11-.12)]	_____	_____	_____
13. If the report requires a changed reference to a departure from GAAP regarding the prior period presented, does the explanatory paragraph in the report include the appropriate language? [SSARS 2, pars. 14-15 (AR 200.14-.15)]	_____	_____	_____
14. If the financial statements of the prior period presented have been changed, has the predecessor or successor reported on them as restated? [SSARS 2, pars. 25-26 (AR 200.25-.26)]	_____	_____	_____
15. If the current-period financial statements were reviewed and the financial statements of the prior period presented were audited and the audit report has not been reissued, does the current-period report include a separate paragraph that contains the appropriate language? [SSARS 2, par. 28 (AR 200.28)]	_____	_____	_____

**Predecessor's Review Report**

16. If the predecessor accountant does not reissue his or her compilation or review report on the prior-period financial statements, has the successor:			
a. Made appropriate reference in the report to the predecessor's report in accordance with paragraphs .17 to .19 of SSARS 2?	_____	_____	_____
or			
b. Performed a compilation, review, or audit of the statements of the prior period and reported on them accordingly? [SSARS 2, pars. 16-19 (AR 200.16-.19)]	_____	_____	_____



**18.500 ILLUSTRATIVE FINANCIAL STATEMENTS, NOTES, AND AUDITOR'S REPORT**

**Independent Auditor's Report**

To the Shareholders and Board of Directors  
Private Company and Subsidiaries

We have audited the accompanying balance sheet of Private Company and Subsidiaries as of December 31, 19X2, and the related consolidated statements of operations, shareholders' equity and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Private Company and Subsidiaries at December 31, 19X2 and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

*[Signature]*

*[Date]*

## ILLUSTRATIVE BALANCE SHEET

Private Company and Subsidiaries  
Consolidated Balance Sheet

December 31, 19X2

**Assets****Current Assets:**

Cash and cash equivalents	\$ 8,196
Accounts receivable	133,616
Inventories	99,194
Prepaid expenses and other current assets	21,193
Deferred income taxes	31,496
Assets held for sale at estimated realizable value	<u>45,535</u>
<b>Total current assets</b>	<b>339,230</b>

Property, plant and equipment, net	118,667
Intangibles	87,891
Other assets	53,198
Deferred income taxes	<u>14,010</u>
<b>Total Assets</b>	<b><u>\$612,996</u></b>

**Liabilities and Shareholders' Equity****Current Liabilities:**

Short-term borrowings and current maturities of long-term debt	\$ 6,217
Accounts payable	62,777
Accrued expenses	88,660
Income taxes payable	<u>10,398</u>
<b>Total current liabilities</b>	<b><u>168,052</u></b>

Long-term debt, less current maturities	179,075
Accrued postretirement benefits	76,250
Other liabilities	<u>7,114</u>
<b>Total long-term liabilities</b>	<b><u>262,439</u></b>

**Shareholders' Equity:**

Common stock: authorized 37,500,000 shares; issued 15,679,933	21,223
Additional paid-in capital	163,022
Retained earnings	291,422
Cumulative translation adjustments	(4,510)
Common stock in treasury, at cost, 5,806,094 shares	<u>471,157</u> <u>(288,652)</u>
<b>Total shareholders' equity</b>	<b><u>182,505</u></b>
<b>Total liabilities and shareholders' equity</b>	<b><u>\$612,996</u></b>

The accompanying notes are an integral part of these financial statements.

**Private Company and Subsidiaries  
Consolidated Statement of Operations**

**For the Year Ended December 31, 19X2**

<b>Net Sales</b>	\$809,138
Cost of sales	584,194
Selling, general, and administrative expenses	163,951
Disposition of businesses and restructuring	<u>42,800</u>
<b>Total operating costs and expenses</b>	<u>790,945</u>
<b>Operating Earnings</b>	18,193
Interest expense	(13,565)
Interest income	<u>2,125</u>
Income before provision for income taxes	6,753
Provision for income taxes	<u>(2,157)</u>
Income before cumulative effect of accounting change	4,596
Cumulative effect of accounting change	<u>(46,200)</u>
<b>Net loss</b>	<u><u>\$(41,604)</u></u>

The accompanying notes are an integral part of these financial statements.



**Private Company and Subsidiaries  
Consolidated Statement of Shareholders' Equity**

**For the Year Ended December 31, 19X2**

	<u>Common Stock</u>	<u>Additional Paid-In Capital</u>	<u>Retained Earnings</u>	<u>Cumulative Translation Adjustments</u>	<u>Common Stock In Treasury</u>
<b>Balance at December 31, 19X1</b>	\$21,106	\$156,733	\$350,654	\$2,747	\$(293,022)
Net loss	—	—	(41,604)	—	—
Dividends declared	—	—	(17,628)	—	—
Exercise of stock options and savings and stock ownership plan funding	117	6,289	—	—	4,370
Translation adjustments	—	—	—	(7,257)	—
<b>Balance at December 31, 19X2</b>	<u>\$21,223</u>	<u>\$163,022</u>	<u>\$291,422</u>	<u>\$4,510</u>	<u>(\$88,652)</u>

The accompanying notes are an integral part of these financial statements.

**Private Company and Subsidiaries  
Consolidated Statement of Cash Flows**

**For the Year Ended December 31, 19X2**

**Cash flows from operating activities:**

Net loss	\$ (41,604)
Adjustments to reconcile net loss to net cash from operating activities:	
Cumulative effect of accounting changes	46,200
Disposition of businesses and restructuring	42,800
Deferred income taxes	(18,998)
Depreciation and amortization	26,369
Pension credits	(8,280)
Undistributed earnings of affiliates	(927)
Changes in assets and liabilities, net of effects from acquisitions and divestitures:	
Accounts receivable	(1,948)
Inventories	(27)
Prepaid expenses and other current assets	(2,536)
Accounts payable	4,496
Accrued expenses	(10,320)
Income taxes	<u>(7,950)</u>
Net cash from operating activities	<u>27,275</u>

**Cash flows from investing activities:**

Proceeds from dispositions	3,088
Capital expenditures	(24,658)
Payments from acquisitions, net of cash acquired	(28,653)
Dividends from non-consolidated subsidiaries	245
Other, net	<u>(723)</u>
Net cash from investing activities	<u>(50,701)</u>

**Cash flows from financing activities:**

Net change in short-term borrowings, including current maturities of long-term debt	(964)
Proceeds from issuance of long-term debt	102,065
Redemption of long-term debt	(65,258)
Dividends paid	(17,541)
Proceeds from issuance of common stock	<u>5,132</u>
Net cash from financing activities	<u>23,434</u>
Effect of exchange rate changes on cash	<u>(988)</u>
Net changes in cash and cash equivalents	(980)
Cash and cash equivalents at beginning of year	<u>9,176</u>
Cash and cash equivalents at end of year	<u>\$8,196</u>

The accompanying notes are an integral part of these financial statements.

## Private Company and Subsidiaries Notes to Financial Statements

### Note A: Summary of Significant Accounting Policies

- Nature of Operations

Private Company and Subsidiaries (the "Company") is predominantly engaged in the production and sale of high-precision tools for use in the construction industry. The Company is also engaged in the construction of small commercial buildings in Canada. This work is usually performed under fixed-price contracts.

- Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

- Consolidation

The consolidated financial statements of the Company include the accounts of Private Company and its wholly owned subsidiaries. Intercompany transactions and accounts have been eliminated. Investments in nonconsolidated companies where management exercises significant influence are accounted for using the equity method.

- Cash Equivalents

Holdings of highly liquid investments with original maturities of three months or less and investments in money market funds are considered to be cash equivalents by the Company.

- Inventories

Inventories are valued using the last-in, first-out (LIFO) method at certain domestic units. Remaining inventories are valued using the first-in, first-out (FIFO) method. All inventories are stated at the lower of cost or market.

- Property

Property, plant and equipment are recorded at cost less accumulated depreciation and amortization. Depreciation and amortization are computed using the straight-line method over the estimated useful lives of assets. Leasehold improvements are amortized over the life of the related asset or the life of the lease, whichever is shorter.

- Intangibles

Intangible assets are amortized on a straight-line basis over periods not exceeding 40 years.

- Foreign Currency Translation

Foreign currency transactions and financial statements of foreign subsidiaries are translated into U.S. dollars at prevailing or current rates respectively, except for revenue, costs and expenses which are translated at average current rates during each reporting period. Gains and losses resulting from translation of financial statements are excluded from the statement of operations and are credited or charged directly to a separate component of shareholders' equity.

- Revenue Recognition

The percentage-of-completion method of accounting is followed for long-term contracts. Under this method, earnings accrue as the contract progresses toward completion, based on the percentage of costs incurred or the units of product delivered. Revenues are primarily recognized as products are shipped and services rendered.

- Income Taxes

The Company accounts for its income taxes using Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes*, which requires recognition of deferred tax liabilities and assets for the expected future tax consequences of events that have been included in the financial statements or tax returns. Under this method, deferred tax liabilities and assets are determined based on the difference between the financial statement and tax bases of assets and liabilities, using enacted tax rates in effect for the year in which the differences are expected to reverse.

#### Note B: Accounts Receivable

Accounts receivable are net of allowances for returns and doubtful accounts of \$4,416 at December 31, 19X2.

#### Note C: Inventories

Inventories at December 31, 19X2 consisted of the following:

Finished goods	\$29,778
Work in process	31,539
Raw material and purchased parts	<u>54,792</u>
Total FIFO cost	116,109
Excess of FIFO cost over LIFO inventory value	<u>(16,915)</u>
Net carrying value	<u>\$99,194</u>

Inventories valued using LIFO were approximately \$39,950 at December 31, 19X2. During 19X2 reductions in inventory quantities resulted in liquidations of LIFO inventory layers carried at lower costs prevailing in prior years as compared with the cost of 19X2 purchases. The effects were to reduce the amount of beginning LIFO reserve and increase 19X2 pretax income by \$3,500. Had cost of sales related to the LIFO inventory layers that were liquidated been valued using current costs, the effects would have been to decrease 19X2 net earnings by \$1,950 in 19X2.

Progress payments, netted against work in process at year end, were \$1,310 in 19X2.

**Note D: Contracts in Progress**

Contracts in progress of \$13,050 at December 31, 19X2 is included in prepaid expenses and other assets. Contracts in progress represent revenue recognized on a percentage-of-completion basis over related progress billings of \$30,008 at December 31, 19X2. Substantially all contracts in progress at year-end are billed during the subsequent year.

**Note E: Property, Plant and Equipment**

Property, plant and equipment at December 31, 19X2 consisted of the following:

Land	\$5,750
Buildings and leasehold improvements	73,173
Machinery and equipment	<u>206,786</u>
	285,709
Less accumulated depreciation and amortization	<u>(167,042)</u>
	<u>\$118,667</u>

**Note F: Income Taxes**

At December 31, 19X2, the Company had net operating loss and tax credit carryforwards for income tax purposes of approximately \$45,350 and \$6,350, respectively, which expire in years 19X3 through 20X2 and acquired deductible temporary differences of approximately \$24,450. These carryforwards and deductible temporary differences resulted from prior year acquisitions. For financial reporting purposes, a valuation allowance of \$21,600 has been recognized to offset the deferred tax assets related to these items.

The net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes are reflected in deferred income taxes. Significant components of the Company's deferred tax assets and liabilities as of December 31, 19X2 are as follows:

Deferred tax assets:	
Acquired tax benefits and basis differences	\$ 32,987
Other postretirement employee benefits	30,647
Losses on dispositions and restructuring	17,399
Inventory	5,877
Warranty	2,341
Vacation pay	1,940
Bad debt allowances	1,137
Other	<u>9,575</u>
Total deferred tax assets	101,903
Valuation allowance for deferred tax assets	<u>(21,600)</u>
	<u>80,303</u>
Deferred tax liabilities:	
Accelerated depreciation	14,860
Pension credits	9,329
Other	<u>10,608</u>
Total deferred tax liabilities	<u>34,797</u>
Net deferred tax assets	<u>\$ 45,506</u>

Significant components of the provision for income taxes for the year ended December 31, 19X2 attributable to continuing operations are as follows:

Current:		
Federal		\$ 1,503
State		<u>4,049</u>
Total current		<u>5,552</u>
Deferred:		
Federal		(3,008)
State		<u>(387)</u>
Total deferred		<u>(3,395)</u>
		<u>\$ 2,157</u>

Consolidated U.S. federal income tax returns have been examined by the IRS through December 31, 19X1. The reconciliation of income tax attributable to continuing operations computed at the federal statutory tax rate to income tax expense is:

Tax at federal statutory rate	\$2,296	34.0
State and local income taxes, net of federal benefit	236	3.5
Goodwill amortization	(264)	(3.9)
Other, net	<u>(111)</u>	<u>(1.6)</u>
	<u>\$2,157</u>	<u>32.0</u>

#### Note G: Debt

Commercial Paper — 4.1%	\$10,930
Money Market Loans — 4.0%	70,750
Bankers Acceptance — 3.7%	4,966
Notes due 19X5 — 7.14%	12,500
Variable Rate Industrial Revenue Bonds due 20X0–20X4;	
no stipulated principal repayments prior to maturity	15,750
5 <sup>3</sup> / <sub>4</sub> % Convertible Subordinated Debentures due 20X2	50,000
5 <sup>5</sup> / <sub>8</sub> –6 <sup>1</sup> / <sub>2</sub> % Industrial Revenue Bonds due 20X0–20X4;	
no stipulated principal repayments prior to maturity	5,607
Capitalized Lease Obligations	3,297
5% Development Loan	2,525
Other Long-Term Borrowings	<u>7,358</u>
	183,683
Less current maturities	<u>4,608</u>
	<u>\$179,075</u>

Maturities of long-term debt through 19X7 are: 19X3 — \$4,608; 19X4 — \$1,943; 19X5 — \$13,241; 19X6 — \$91,119; 19X7 — \$424.

The Company issued \$50,000 of 5<sup>3</sup>/<sub>4</sub>% of Convertible Subordinated Notes due 20X2 in April 19X2. The Notes are convertible into Private Company common stock at a conversion rate of 6.33 shares of Common Stock for each \$1 principal amount of Notes (equivalent to a conversion price of approximately \$39.00 per share). The proceeds from the Notes were used to repay \$12,500 of commercial paper and money market loans, \$10,600 of commercial paper and money market loans (incurred to redeem \$10,550 of its 8<sup>7</sup>/<sub>8</sub>% Debentures due 19X9 and the associated premium), and the balance to repay other commercial paper and money market loans with a weighted average interest rate of 4.36%, and for general corporate purposes.

In July 19X2, the company entered two revolving credit agreements with expiration dates of July 15, 19X3 and July 18, 19X5. Each agreement permits borrowings of up to \$100,000 at interest rates offered to prime customers. The agreement expiring July 18, 19X5 is convertible into a one-year term loan.

Money market loans and commercial paper are classified as long-term debt as the company intends to refinance them on a long-term basis either through continued short-term borrowing or utilization of available credit facilities.

#### Note H: Fair Values of Financial Instruments

Disclosure of fair value information about certain financial instruments, whether or not recognized in the balance sheet, for which it is practicable to estimate that value is required by Financial Accounting Standards Board Statement (SFAS) No. 107, *Disclosure About Fair Value of Financial Instruments*. The following methods and assumptions were used in estimating fair values:

- Cash and cash equivalents: The carrying amount reported in the balance sheet approximates fair value.
- Short- and long-term debt: The carrying amounts of the Company's borrowings under its revolving credit agreements, as well as all short-term borrowings, approximate their fair values. The fair values of the Company's long-term debt were estimated using discounted cash flow analysis, based on the Company's current incremental borrowing rates for similar arrangements.

Financial guarantees and letters of credit were issued by the Company in the ordinary course of business as required. The fair value was based upon the face value of the underlying instruments.

The carrying amounts and fair values of the Company's financial instruments as December 31, 19X2 are as follows:

	<u>Carrying Amounts</u>	<u>Fair Value</u>
Cash and cash equivalents	\$ 8,196	\$ 8,196
Short- and long-term debt	185,292	185,292
Financial guarantees and letters of credit	—	11,150

**Note I: Contingencies and Commitments**

- **Litigation**

The Company and certain of its subsidiaries are defendants in legal proceedings that arise in the ordinary course of its business activities. Although the ultimate disposition of these proceedings is not presently determinable, management does not expect the outcome to have a material adverse effect on the Company's financial position.

- **Leases**

The future minimum rental payments under leases with remaining noncancelable terms in excess of one year are:

<b>Year Ending December 31,</b>	
19X3	\$11,900
19X4	8,550
19X5	6,400
19X6	4,850
19X7	3,850
Subsequent to 19X7	<u>11,550</u>
Total minimum payments	<u>\$47,100</u>

Included in these amounts are future minimum lease payments of equipment as follows: 19X3 — \$3,400; 19X4 — \$2,300; 19X5 — \$1,950; 19X6 — \$1,700; 19X7 — \$1,500; and thereafter \$5,600.

Minimum payments exclude sublease rentals of \$1,500 under noncancelable subleases. Total rent expense in 19X2 was \$12,450.

**Note J: Environmental Matters**

The Company is involved in various stages of investigation and remediation relative to environmental protection matters, arising out of its own initiative, from indemnification of purchasers of divested operations, or from legal or administrative proceedings, some of which include waste disposal sites. One of the Company's facilities has been listed on the National Priorities List under the Comprehensive Environmental Response, Compensation and Liability Act of 19Y0, as amended by the Superfund Amendments and Reauthorization Act of 19Y6 ("CERCLA"); the Company is engaged in litigation concerning the appropriateness of that listing. In certain instances, the Company may be exposed to joint and several liability for remedial action or damages. The Company, along with several other entities, has been named as a Potentially Responsible Party for remedial costs at certain third-party sites listed on the National Priorities List under CERCLA.

The potential costs related to such matters and the possible impact on future operations are uncertain due in part to the complexity of government laws and regulations and their interpretations, the varying costs and effectiveness of cleanup technologies, the uncertain level of insurance or other types of recovery, and the questionable level of the Company's responsibility. In management's opinion, after considering reserves established for such purposes, remedial actions for compliance with the present laws governing the protection of the environment are not expected to have a material adverse impact on the Company's results of operations or financial position.



**Note K: Capital Stock**

- Preferred Stock

Five million shares of cumulative preferred stock, par value \$1.00 per share, are authorized but unissued.

- Common Stock

The 979,780 shares issued through 19W9 have a par value of \$3.34 per share. Shares issued since then have a par value of \$1.00 per share.

- Treasury Stock

Balance, December 31, 19X1	5,894,234
Common stock reacquired	2,805
Common stock issued	<u>(90,945)</u>
Balance, December 31, 19X2	<u>5,806,094</u>

- Common Stock Purchase Rights

The Board of Directors declared a dividend distribution of two common stock purchase rights (Rights) for each share of common stock on June 5, 19W6. The rights expire on June 25, 19W6, unless redeemed earlier by the Company. Two Rights entitle its registered holder to purchase from the Company one share of common stock at a price of \$75 per share, subject to adjustment to prevent dilution.

The Rights are not exercisable and cannot be transferred separately from the common stock until: (1) a person or group publicly announces the acquisition of, or obtains the right to acquire, 30% or more of the outstanding shares of the Company's common stock; or (2) a tender or exchange offer is announced or commenced that would result in such an acquisition. Within 15 days after such a 30% interest has actually been obtained, the Company is entitled to redeem all of the Rights at a price of five cents per Right.

**Note L: Employee Benefit Plans**

- Pension Plans

Substantially all salaried and hourly paid employees are covered by the Company's pension plans. Benefit payments are provided by the plans, using a formula based on an employee's compensation and length of service or, in some cases, stated amounts for each year of service. The Company funds pension plans in amounts equal to the minimum funding requirements of the Employee Retirement Income Security Act of 19V4, plus additional amounts that may be approved from time to time. Substantially all plan assets are invested in cash and short-term investments or listed stocks and bonds and real estate. Plan assets and obligations of subsidiaries are not considered material.

The periodic net pension income for 19X2 related to continuing operations is comprised of the following:

Service cost — benefits earned during the period	\$ 5,705
Interest cost on projected benefit obligation	15,090
Actual return on assets	(9,343)
Net amortization and deferral	(19,732)
Net pension income	<u>\$(8,280)</u>

The following table shows the plan's funded status and amounts recognized in the balance sheet as of December 31, 19X2.

**Actuarial present value of benefit obligations:**

Vested benefit obligation	\$(161,064)
Accumulated benefit obligation	(173,669)
Projected benefit obligation	(185,092)
Fair value of plan assets	263,150
Plan assets in excess of projected benefit obligation	78,058
Unrecognized net gain	(25,524)
Prior service cost not yet recognized in net pension cost	5,908
Unrecognized net asset	(26,895)
Prepaid pension cost	<u>\$31,547</u>

**The actuarial assumptions used were:**

Discount rate	8.75%
Rate of increase in compensation levels	6.50%
Expected long-term rate of return on assets	9.50%

● **Nonpension Retirement Benefits**

The Company and its subsidiaries have postretirement plans that provide health and life insurance benefits for retirees. Some of these plans require employee contributions at varying rates. Not all employees are eligible to receive these benefits, with eligibility depending on the plan in effect at a particular location.

The Company changed its method of accounting for postretirement benefits other than pensions from the pay-as-you-go method to the accrual method, as required by SFAS No. 106, on January 1, 19X2. A charge of \$77,500 to the 19X2 earnings, net of approximately \$31,300 of income tax benefits, was the result of the cumulative effect of adopting SFAS No. 106 as of January 1, 19X2.

The accumulated postretirement benefit obligation was determined using the terms of the Company's various plans, together with relevant actuarial assumptions and healthcare cost trend rates projected at annual rates ranging from 13% in 19X2 and 12.1% in 19X3 to 6% through the year 20X4 and a discount rate of 8.75%.

A 1% annual increase in these assumed cost trend rates would increase the accumulated postretirement benefit obligation by approximately \$12,750 and annual service costs by approximately \$1,350.

The net periodic postretirement benefit cost related to continuing operations for 19X2 is comprised of the following:

Service cost-benefits attributed to service during the period	\$ 925
Interest cost on the accumulated postretirement benefit obligation	6,460
Net amortization and deferral	<u>(60)</u>
Net periodic postretirement benefit cost	<u>\$7,325</u>

The following table shows the plans' funded status and amounts recognized in the balance sheet as of December 31, 19X2 and January 1, 19X2 (the date of adoption):

	<u>December 31, 19X2</u>	
	<u>Health</u>	<u>Life</u>
Accumulated postretirement benefit obligation:		
Retirees	\$(50,809)	\$ (6,266)
Fully eligible active plan participants	(3,454)	(2,095)
Other active plan participants	<u>(5,625)</u>	<u>(1,097)</u>
Total	(59,888)	(9,458)
Unrecognized prior service cost	<u>(11,403)</u>	<u>—</u>
Accrued postretirement benefit cost	(71,291)	(9,458)
Less amounts classified as current	<u>4,000</u>	<u>500</u>
	<u>\$(67,291)</u>	<u>\$ (8,958)</u>

	<u>January 1, 19X2</u>	
	<u>Health</u>	<u>Life</u>
Accumulated postretirement benefit obligation:		
Retirees	\$(50,268)	\$ (6,273)
Fully eligible active plan participants	(6,425)	(1,927)
Other active plan participants	<u>(11,699)</u>	<u>(908)</u>
Total	(68,392)	(9,108)
Unrecognized prior service cost	<u>—</u>	<u>—</u>
Accrued postretirement benefit cost	(68,392)	(9,108)
Less amounts classified as current	<u>—</u>	<u>—</u>
	<u>\$(68,392)</u>	<u>\$ (9,108)</u>

The unrecognized prior service cost at December 31, 19X2 represents unamortized amounts for plan amendments resulting from revisions to Company-sponsored health plans during 19X2 which reduced benefit levels.

**Note M: Discontinued Operations**

In 19X0, the Company adopted a plan to dispose of substantially all of its sea transportation sector, comprised of its New York Boat and General Seaway units and several minor related businesses. During the first half of 19X1, the Company completed the sale of substantially all the net assets of New York Boat and General Seaway. During the fourth quarter of 19X1, the Company provided a \$4,900 after-tax charge relating to the discontinued businesses. Certain operations related to these businesses have not been sold or disposed of as of December 31, 19X2 and certain outstanding obligations remain unsettled.

**Note N: Supplemental Cash Flow Information**

During 19X2 the Company paid \$14,201 and \$13,369 for interest and taxes, respectively.



**CHAPTER 19**  
**REPORTING ON AUDITED FINANCIAL STATEMENTS**

**Table of Contents**

<b><u>Section</u></b>		<b><u>Page</u></b>
19.000	CONCEPTS OF REPORTING	19-5
19.001	Applicability	19-5
19.002	Association With Financial Statements	19-5
19.004	Report Preparation	19-5
19.005	Reports on Audited Financial Statements	19-7
19.100	AUDITOR'S REPORT	19-7
19.102	Modifications of the Standard Auditor's Report	19-7
19.103	Audit Reporting Summary	19-9
19.104	Scope Limitations	19-13
19.105	First-Year Audits	19-14
19.106	Departures From GAAP	19-14
19.106	Unacceptable Principles	19-14
19.109	Inadequate Disclosure	19-14
19.110	Errors, Irregularities, and Illegal Acts	19-14
19.112	Failure to Apply an Authoritative Pronouncement (Rule 203 of the AICPA <i>Code of Professional Conduct</i> )	19-15
19.113	Consistency Exceptions	19-15
19.116	Uncertainties	19-16
19.117	Uncertainties Not Requiring Modification of the Opinion	19-16

## CHAPTER 19

### REPORTING ON AUDITED FINANCIAL STATEMENTS

#### Table of Contents (Continued)

<b><u>Section</u></b>		<b><u>Page</u></b>
19.118	Scope Limitations	19-16
19.119	Departures From GAAP	19-16
19.122	Resolution of the Uncertainty	19-17
19.124	Going-Concern Uncertainties	19-17
19.200	REPORT BASED ON WORK OF OTHER AUDITORS	19-17
19.203	Decision to Refer to Other Auditor's Work	19-18
19.204	Decision Not to Refer to Other Auditor's Work	19-18
19.205	Procedures for Both Methods	19-18
19.300	REPORTING ON COMPARATIVE FINANCIAL STATEMENTS	19-19
19.301	Prior-Period Audit Performed by Predecessor	19-19
19.303	Reporting on Audited and Unaudited Financial Statements in Comparative Form	19-19
19.400	REPORTING ON SUPPLEMENTARY INFORMATION	19-19
19.403	Common Interest Realty Associations (CIRA)	19-20
19.500	OTHER REPORTING SITUATIONS	19-20
19.501	Reporting on a Single Statement	19-20
19.502	Relying on the Work of a Specialist	19-20
19.504	Lack of Independence	19-21
19.505	Emphasizing a Matter in an Unqualified Opinion	19-21
19.507	Updated Opinion Differs From Previous Opinion	19-21
19.510	Reissuance of Audit Reports as Predecessors	19-22
19.513	Reissuance of the Independent Auditor's Report Subsequent to the Date of the Original Issue	19-22
19.515	Subsequent Discovery of Facts Existing at Report Date	19-22

**CHAPTER 19**  
**REPORTING ON AUDITED FINANCIAL STATEMENTS**

**Table of Contents (Continued)**

<u>Section</u>		<u>Page</u>
19.600	SAMPLE AUDITOR'S REPORTS	19-23
19.601	Single Period Financial Statements	19-24
19.602	Comparative Financial Statements	19-25
19.603	Qualified Opinion — Scope Limitation	19-26
19.604	Disclaimer of Opinion — Scope Limitation	19-27
19.605	First-Year Audit — Beginning Balances Not Audited	19-28
19.606	Qualified Opinion — Departure From GAAP	19-29
19.607	Adverse Opinion — Departure From GAAP	19-30
19.608	Qualified Opinion — Inadequate Disclosure	19-31
19.609	Explanatory Paragraph — Change of GAAP	19-32
19.610	Change to an Unacceptable Principle — Qualified Opinion	19-33
19.611	Client Fails to Provide Reasonable Justification for a Change Between Alternative Acceptable Principles	19-34
19.612	Uncertainty	19-35
19.613	Going-Concern Uncertainty	19-36
19.614	Report Indicating Divided Responsibility	19-37
19.615	Predecessor Declines Reissue — Prior Period Unqualified	19-38
19.616	Predecessor Declines Reissue — Prior Period Qualified	19-39
19.617	Predecessor Declines Reissue — Prior Period Unqualified — Restatement Subsequently Made	19-40
19.618	Current Year Audited — Prior Period Reviewed	19-41
19.619	Current Year Audited — Prior Period Compiled	19-42
19.620	Unqualified Report on Supplementary Information	19-43
19.621	Disclaimer on Part of Supplementary Information	19-44
19.622	Disclaimer on All Supplementary Information	19-45



## CHAPTER 19

### REPORTING ON AUDITED FINANCIAL STATEMENTS

#### Table of Contents (Continued)

<b><u>Section</u></b>		<b><u>Page</u></b>
19.623	Report on Basic Financial Statements Qualified — Qualified Opinion on Supplementary Information	19-46
19.624	CIRA Financial Statements — Required Supplementary Information Not Included	19-47
19.625	Report on Balance Sheet — Balance Sheet Only Presented	19-48
19.626	Report on Balance Sheet — Disclaimer on Other Statements	19-49
19.627	Lack of Independence (Public Companies Only)	19-50
19.628	Emphasis of a Matter	19-51
19.629	Subsequent Restatement of Prior Period to Conform With GAAP	19-52

## CHAPTER 19

### REPORTING ON AUDITED FINANCIAL STATEMENTS

#### 19.000 CONCEPTS OF REPORTING

##### Applicability

**19.001** This chapter is designed for use in audit engagements for nonpublic business entities using generally accepted accounting principles (GAAP). Reporting guidance and sample reports for compilation and review engagements are included in the *IPS Compilation and Review Manual* and in Chapter 20 of this Manual.

##### Association With Financial Statements

**19.002** Auditors are associated with financial statements when—

- They consent to the use of their name in documents containing financial statements.
- They submit financial statements they prepared or assisted in preparing to clients or others, even though the firm's name is not included with the statements.

**19.003** It is important to note that this definition applies to situations in which the auditor has been engaged to *audit* the financial statements. It does not apply to compilation and review engagements.

##### Report Preparation

**19.004** Firms should develop standard policies and procedures for preparing and issuing reports. The following are some suggested report preparation policies:

- *Letterhead.* The report should be presented on firm letterhead.
- *Addressee.* The report should be addressed to the board of directors, stockholders, partners, general partner, proprietor, or to the company whose financial statements are being audited. If the firm was engaged by others, the report should be addressed thereto.

The Board of Directors  
XYZ Company, Inc.  
City, State

The Stockholders and Board of Directors  
XYZ Company, Inc.  
City, State

- *Salutation.* A salutation should not be included on the report.
- *Report Signing.* The firm name should be manually signed by the engagement partner after completing the Financial Statement Control Form in section 13.604 of Chapter 13. The words *Certified Public Accountant(s)* should be excluded from the signature if they are a normal part of the firm's letterhead.
- *Report Dating.* Audit reports should be dated as of the last day of field work. The date should be presented at the bottom of the page along with the city and state, if not included in the firm letterhead, as follows:

City, State  
April 5, 19Y

If significant subsequent events are discovered before the report is issued, but after the completion of field work, the report should be dual-dated for the subsequent events. Subsequent events affecting previously issued reports that are being reissued will also cause the report to be dual-dated. The following illustrates dual-dating:

City, State  
February 26, 19Y, except for Note X as to which the date is April 5, 19Y

- *Level of Service.* The type of report to be issued and level of service to be performed should be outlined in the engagement letter. The letter should be revised for any significant changes from the original understanding with the client, such as a step-up or step-down in the level of service.

The engagement partner should approve any step-up or step-down in the level of service. A step-up in the level of service may occur after a revised understanding with the client. A step-down in the level of service should occur only after carefully evaluating the reasons for the change. The reasons for the change may also affect the report at a lower level of service. Limitations in the scope of an audit, for example, may preclude issuing a review or compilation report.

If more than one level of service is performed for financial statements of the same period — for example, compilation and audit — the financial statements should be accompanied only by the report on the highest level of service performed.

## Reports on Audited Financial Statements

**19.005** Generally accepted auditing standards (GAAS) establish reporting responsibilities. The four standards of reporting stated in AICPA Statement on Auditing Standards (SAS) No. 1, *Codification of Auditing Standards and Procedures* (AU 150.02), are —

1. The report shall state whether the financial statements are presented in accordance with GAAP.
2. The report shall identify those circumstances in which GAAP has not been consistently applied in the current period in relation to the preceding period.
3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
4. The report shall contain either an expression of opinion regarding the financial statements taken as a whole, or a statement that an opinion cannot be expressed. When an opinion cannot be expressed, the reasons should be stated. In all cases, the report should contain a clear-cut indication of the degree of responsibility, if any, the auditor is taking.

### 19.100 AUDITOR'S REPORT

**19.101** The standard auditor's report prescribed by SAS No. 58, *Reports on Audited Financial Statements* (AU 508), should be used when the auditor has formed an opinion, based on the application of GAAS, that the financial statements present fairly, in all material respects, an entity's financial position, results of operations, and cash flows in accordance with GAAP. It should address all financial statements presented. Standard auditor's reports for presentations of single-year and comparative financial statements are illustrated in sections 19.601 and 19.602, respectively.

#### Modifications of the Standard Auditor's Report

**19.102** In addition to the standard auditor's reports, SAS No. 58 describes situations that may require auditors to modify the standard report, and also provides illustrations of the appropriate modifying language: These modifications, which are discussed in greater depth in the following sections, are —

1. *Explanatory Language.* A wide variety of situations may arise that require a modification of the standard auditor's report that do not affect the expression of an unqualified opinion. Some of the more common of such situations are uncertainties,<sup>1</sup> going-concern problems, the auditing

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<sup>1</sup> As this Manual went to press, the Auditing Standards Board had issued an Exposure Draft of a proposed Amendment to Statement on Auditing Standards No. 58, *Reports on Audited Financial Statements*, that would eliminate the required uncertainties paragraph in the auditor's report, if the uncertainties are adequately disclosed in the notes to the financial statements. Auditors should ascertain the status of this pronouncement (by calling AICPA Technical Information Hotline at (800) TO-AICPA) before adding an uncertainties explanatory paragraph to an auditor's report.

- of part of the financial statements by another auditor, or a significant change in accounting principles. The explanatory paragraph for situations that do not affect the auditor's opinion should be placed after the opinion paragraph.
2. *Qualified Opinion.* Qualified opinions result from two general categories of situations: scope limitations and departures from GAAP. A scope limitation arises when the auditor has been unable to perform all of the auditing procedures he or she believes are necessary to express an unqualified opinion on the financial statements. Financial statements containing a material departure from GAAP, including inadequate disclosures in the financial statements, may lead the auditor to qualify his or her opinion. Both situations require that an explanatory paragraph, preceding the opinion paragraph, be included that describes the nature of the scope limitation or the departure from GAAP.
  3. *Disclaimer of Opinion.* A disclaimer of opinion may be required when—
    - The scope of the audit has been restricted so significantly that the auditor does not have a basis for forming an opinion on the financial statements. If the auditor issues a disclaimer of opinion on the financial statements due to a scope limitation, the report should indicate, in a separate explanatory paragraph, why the audit did not comply with generally accepted auditing standards. Also, any reservations regarding the fair presentation of the financial statements in conformity with GAAP should be disclosed.
    - The auditor is not independent. Whenever the auditor is not independent with respect to a public entity whose financial statements have been audited, a disclaimer of opinion should be issued. For nonpublic entities, the firm should issue a compilation report that includes a statement that the firm is not independent. Whenever the auditor is not independent with respect to a public entity whose financial statements have been audited, a disclaimer of opinion should be issued. For nonpublic entities, the firm should issue a compilation report that includes a statement that the firm is not independent. An illustration of a disclaimer of opinion due to a lack of independence is provided in section 19.627.
    - The auditor is associated with the unaudited financial statements of an entity that he or she has not audited or reviewed. If the auditor is associated with financial statements that have not been reviewed or audited, the report should state that an audit or review has not been performed and address the accompanying financial statements.
  4. *Adverse Opinion.* An adverse opinion should be expressed on financial statements that do not present fairly the entity's financial position, results of operations, or cash flows in conformity with GAAP. In other words, the auditor concludes that the financial statements are *not* fairly presented in accordance with GAAP. Issuance of an adverse opinion requires inclusion of an explanatory paragraph, preceding the opinion paragraph, that explains all of the reasons for the adverse opinion and, if practicable, the effects of the subject matter of the adverse opinion on the financial statements.

## Audit Reporting Summary

**19.103** The following summarizes common situations that may result in a report modification of the standard auditor's report, as well as the type of report modification, if any, that should be made.

### Audit Reporting Summary

<u>Situation</u>	<u>Type of Modification</u>
<b>Scope Limitations</b>	
Auditor is unable to perform all necessary auditing procedures (section 19.603)	Qualified opinion
Auditor is unable to form an opinion because of the inability to perform necessary auditing procedures (section 19.610)	Disclaimer of opinion
<b>Uncertainties</b>	
Going-concern problem (section 19.613)	Explanatory paragraph or disclaimer of opinion
Inadequate disclosure of uncertainty	Qualified or adverse opinion
Other uncertainties (section 19.612) <sup>2</sup>	Explanatory paragraph or disclaimer of opinion
<b>Departures From GAAP</b>	
Use of unacceptable principle that affects financial statement items but not the statements as a whole (section 19.606)	Qualified opinion
Use of an unacceptable principle that materially affects financial statements as a whole (section 19.607)	Adverse opinion

<sup>2</sup> As this Manual went to press, the Auditing Standards Board had issued an Exposure Draft of a proposed Amendment to Statement on Auditing Standards No. 58, *Reports on Audited Financial Statements*, that would eliminate the required uncertainties paragraph in the auditor's report, if the uncertainties are adequately disclosed in the notes to the financial statements. Auditors should ascertain the status of this pronouncement (by calling AICPA Technical Information Hotline at (800) TO-AICPA) before adding an uncertainties explanatory paragraph to an auditor's report.

**Audit Reporting Summary**  
(Continued)

<u>Situation</u>	<u>Type of Modification</u>
Inadequate disclosure (section 19.608)	Qualified or adverse opinion
Rule 203 departure (GAAP departure is necessary to keep financial statements from being misleading)	Explanatory paragraph preceding opinion
<b>Financial Statements Containing Errors, Irregularities, and Illegal Acts</b>	
Amounts cannot be determined because of restrictions by client	Qualified or disclaimer of opinion
Amounts are material and not properly disclosed	Qualified or adverse opinion
Amounts and legality of matter are uncertain	Qualified or disclaimer of opinion
Client will not accept report modification	No report should be issued
<b>Change to an Unacceptable Principle</b>	
Change materially affects financial statement items but not the statements as a whole (section 19.610)	Qualified opinion
Change materially affects financial statements as a whole	Adverse opinion
Client fails to provide reasonable justification for a change between alternative acceptable principles (section 19.611)	Qualified opinion
<b>Accounting Principles Not Consistently Applied</b>	
Consistency exception (section 19.609)	Explanatory paragraph
Current period effect not material, but material future effect not expected	Qualified opinion if adequately disclosed in notes

**Audit Reporting Summary**  
(Continued)

<u>Situation</u>	<u>Type of Modification</u>
<b>Reporting on a Single Statement</b>	
Balance sheet only presented (section 19.625)	Modify to refer only to balance sheet
Balance sheet audited, other statements not audited also presented (section 19.626)	Modify to report on balance sheet, disclaimer on other statements
<b>First-year Audit by the Firm</b>	
GAAP determined to be consistent	No modification
GAAP consistency undeterminable	Disclaimer of opinion
Beginning inventory balances not audited, GAAP determined consistent (section 19.605)	Explanatory paragraph; disclaimer on statements of earnings and cash flows
<b>Different Level of Prior-Period Service</b>	
Current period audited, prior period reviewed or compiled (sections 19.618 and 19.619)	Additional paragraph following opinion paragraph describing prior-period review or compilation
Current period reviewed or compiled, prior period audited	Additional paragraph describing prior-period audit
<b>Part of Audit Performed by Other Auditors</b>	
Principal auditor does not rely on other auditor's work (section 19.614)	Modify introductory and opinion paragraphs
Principal auditor assumes responsibility for other auditor's work	No modification



**Audit Reporting Summary**  
(Continued)

<u>Situation</u>	<u>Type of Modification</u>
<b>Prior-Period Audit Performed by a Predecessor</b>	
Predecessor reissues report	No modification
Predecessor does not reissue, prior period unqualified (section 19.615)	Modify introductory paragraph to address predecessor's report and type of opinion
Prior period is qualified, restatement is necessary (section 19.616)	Modify introductory paragraph to address predecessor's report and type of opinion
Prior period qualified, restatement subsequently make (section 19.617)	Modify introductory paragraph to address predecessor's report and restatement
<b>Relying on the Work of Specialists</b>	
Unable to resolve difference between specialist's findings and financial statement representations (scope limitation)	Qualified or disclaimer of opinion
<b>Representations in financial statements not in accordance with GAAP</b>	
Material effect on financial statement items, but not the financial statements as a whole	Qualified opinion
Material effect on the financial statements as a whole	Adverse opinion
<b>Lack of Independence</b>	
Nonpublic companies	Step down to compilation and disclose lack of independence
Public companies (section 19.627)	Disclaimer of opinion

**Audit Reporting Summary**  
(Continued)

<u>Situation</u>	<u>Type of Modification</u>
Emphasis of a Matter	
Desire to emphasize a matter that does not affect an unqualified opinion (section 19.628)	Explanatory paragraph following opinion paragraph
Financial Statements Containing Supplementary Information	
Information subjected to auditing procedures (section 19.620)	Standard report on supplementary information
Part of information subjected to auditing procedures (section 19.621)	Disclaimer on part of supplementary information; standard report on remainder
No procedures applied to information (section 19.622)	Disclaimer on supplementary information
Report on basic financial statements qualified for scope limitation, departure from GAAP, inconsistent GAAP or uncertainty (section 19.623)	Consider effect of qualification on supplementary information
Disclaimer of opinion on basic financial statements	Disclaimer on supplementary information
Supplementary information not presented in accordance with GAAP	Adverse opinion on supplementary information

**Scope Limitations**

**19.104** Restrictions on the scope of an audit, whether imposed by the client or by circumstances such as the timing of the auditor's work, the inability to obtain sufficient, competent evidential matter, or an inadequacy in the client's accounting records, may require a qualified opinion or a disclaimer of opinion. Client-imposed restrictions that significantly limit the scope of an audit ordinarily should result in a disclaimer of opinion on the financial statements. Deciding whether to qualify or disclaim is a matter of judgment, and generally the primary factor in this decision is the materiality of the financial statement items affected. However, other factors should be considered, such as the pervasiveness of the effects of the omitted auditing procedures and the nature of the financial statement items affected. Illustrated in sections 19.603 and 19.604, respectively are a qualified opinion and a disclaimer of opinion due to a scope limitation.

**19.105 First-Year Audits.** When the firm is engaged for an initial audit, the scope of work must cover beginning balances that affect the statements of earnings and retained earnings, and the statement of cash flows. If the firm is able to satisfy itself as to the beginning balances, no mention is required in the report. If the firm cannot satisfactorily complete procedures for material beginning balances, a disclaimer of opinion will be required for the statements of earnings and retained earnings and for the statement of cash flows. The firm should also perform limited procedures to determine that GAAP has been consistently applied between periods. If the inadequacy of records prevents the firm from doing so, an opinion cannot be expressed on the current year financial statements. Section 19.605 illustrates reporting language when the beginning inventory amount cannot be satisfactorily audited.

### Departures From GAAP

**19.106 Unacceptable Principles.** Significant departures from GAAP require that the auditor issue either a qualified or an adverse opinion. Choosing between a qualified or an adverse opinion depends on the magnitude of the departure. While the materiality of the effects of the departure is a primary consideration, the auditor should also consider the pervasiveness of the departure, that is, the number of financial statement items affected, the importance of the departure to the entity's business, and the dollar effect of the departure on individual financial statement items as well as on the statements as a whole.

**19.107** For both qualified and adverse opinions, an explanatory paragraph should be included, preceding the opinion paragraph, that describes all of the substantive reasons for the auditor's opinion and the effects on the financial statements, if readily determinable. If it is not practical to determine the effects of the departure, the explanatory paragraph should contain a statement to that effect. If information about the effects of the departure are described in the notes, the explanatory paragraph can be shortened by referring to the note.

**19.108** The opinion paragraph for a qualified opinion due to a departure from GAAP should include the words *except* or *exception* and a reference to the explanatory paragraph that describes that departure. Adverse opinions should include language such as "do not present fairly" and should also include a reference to the explanatory paragraph. Illustrated in sections 19.606 and 19.607 respectively are qualified and adverse opinions due to a departure from GAAP.

**19.109 Inadequate Disclosure.** Departures from GAAP include not just inappropriate application of accounting principles, but also omitted or inadequate disclosures in the financial statements including omission of the statement of cash flows. Such situations require the auditor to add an explanatory paragraph, preceding the opinion paragraph, that describes the nature of the inadequate or omitted disclosure and, if practical, the information that should have been disclosed. The significance of the omitted or inadequate disclosure will determine whether a qualified or adverse opinion is appropriate. Section 19.608 illustrates a sample qualified opinion due to inadequate disclosure.

**19.110 Errors, Irregularities, and Illegal Acts.** If the financial statements are materially affected by an error, irregularity, or illegal act that has not been properly accounted for and disclosed, a qualified or adverse opinion should be considered. If the auditor is precluded from applying necessary procedures or from obtaining sufficient information to conclude whether an error, irregularity, or illegal act that could be material to the financial statements has occurred, a qualified opinion or a disclaimer of opinion should be issued. All such matters should be discussed immediately with the engagement partner.

**19.111** If a client will not accept modification of the report under the circumstances above, the firm should consider withdrawing from the engagement.

**19.112 Failure to Apply an Authoritative Pronouncement (Rule 203 of the AICPA Code of Professional Conduct).** A qualified or adverse opinion is required if there is a material departure from GAAP, unless conformity with GAAP would cause the financial statements to be misleading. In these rare cases, an unqualified opinion may be issued, with an explanatory paragraph that describes the departure, its approximate effects, if determinable, and the reasons why application of the principle would cause the statements to be misleading.

### Consistency Exceptions

**19.113** Accounting changes affecting consistency include—

- A change from one generally accepted accounting principle to another method, practice, or principle that is different from the one previously used
- A change from an unacceptable to an acceptable principle (correction of an error)
- A change in financial statement classification that significantly affects financial position or results of operations (for example, classification of an item in earnings from operations as other income or expense)
- A change in reporting entity including—
  - Consolidated or combined statements instead of individual company statements
  - Changes in the entities included in consolidated or combined statements

**19.114** Accounting changes not normally affecting consistency include—

- Initial adoption of an existing accounting principle for a new event or transaction
- Insignificant reclassification
- Correction of errors not involving an accounting principle
- Changes in accounting estimates

**19.115** The nature of the accounting change will determine whether prior-period financial statements should be restated or a cumulative adjustment should be included in current earnings. In either event, the change should be disclosed in the notes to the financial statements and in the auditor's report in a separate paragraph following the opinion paragraph. The auditor's concurrence with a change is implicit unless he or she takes exception to the change. The opinion paragraph would be standard unless the change is to an unacceptable principle or method, the change is not justified, or a prospective change of a principle requiring retroactive adjustment is not discussed. In such situations, either a qualified or adverse opinion should be issued. The reports in sections 19.609, 19.610, and 19.611 illustrate the appropriate reporting language for various consistency exceptions.

## Uncertainties

**19.116** Uncertainties are significant circumstances, events, or transactions affecting the financial statements, the outcome of which cannot be reasonably estimated. Uncertainties are a particularly complex area because they can result in a qualified or adverse opinion due to a departure from GAAP, a qualified opinion or disclaimer due to a scope limitation, or merely an explanatory paragraph that does not affect the auditor's opinion. Statement of Financial Accounting Standards (SFAS) No. 5, *Accounting for Contingencies* (CT 59), is the primary authoritative pronouncement for financial statement presentation and disclosure of uncertainties.

**19.117 Uncertainties Not Requiring Modification of the Opinion.** Paragraph 23 of SAS No. 58 (AU 508.23) states that when the auditor has concluded that an uncertainty exists, he or she should consider whether the matter warrants disclosure in the notes to the financial statements and inclusion of an explanatory paragraph in the auditor's report.<sup>3</sup> This assessment is based on the likelihood that the resolution of the uncertainty will result in a material loss. If management and the auditor believe the likelihood of a material loss is "remote," no explanatory paragraph or disclosure would be required. If the likelihood of a material loss is "probable" and, in some instances "reasonably possible,"—but no accrual is made because the amount or range of possible loss cannot be reasonably estimated—the uncertainty should be disclosed in the notes to the financial statements and the auditor should include an explanatory paragraph in the report. The explanatory paragraph should describe the uncertainty and indicate that the outcome cannot presently be determined. This paragraph may be shortened by referring to information in the notes to the financial statements. Because this situation does not result in a modified opinion, no mention should be made of the uncertainty in the introductory, scope, or opinion paragraphs of the report.

**19.118 Scope Limitations.** A qualified opinion or disclaimer of opinion may be required if the auditor is unable to obtain sufficient information to support management's assertions about the uncertainty. In some ways, information about uncertainties may be considered insufficient because it is dependent on future, unknown events. However, if the auditor determines that information did or does exist, but it is unavailable to him or her (for example, because the information was destroyed or management will not allow the auditor to have access to it), the auditor should consider modifying the report for a scope limitation.

**19.119 Departures From GAAP.** SAS No. 58, paragraph 19 (AU 508.19), describes three categories of departures from GAAP involving uncertainties:

- Inadequate disclosure
- Inappropriate accounting principles
- Unreasonable accounting estimates

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<sup>3</sup> As this Manual went to press, the Auditing Standards Board had issued an Exposure Draft of a proposed Amendment to Statement on Auditing Standards No. 58, *Reports on Audited Financial Statements*, that would eliminate the required uncertainties paragraph in the auditor's report, if the uncertainties are adequately disclosed in the notes to the financial statements. Auditors should ascertain the status of this pronouncement (by calling AICPA Technical Information Hotline at (800) TO-AICPA) before adding an uncertainties explanatory paragraph to an auditor's report.

**19.120** As mentioned in section 19.116, SFAS No. 5 sets forth the disclosure requirements for contingencies. A qualified or adverse opinion due to a departure from GAAP may be necessary if the auditor concludes that the uncertainty has not been appropriately disclosed in accordance with SFAS No. 5.

**19.121** Also, a departure from GAAP may exist if management has made inappropriate estimates of future events in applying accounting principles (such as the use of unreasonable expected lives of depreciable assets for calculating depreciation) or in making other accounting estimates.

**19.122 Resolution of the Uncertainty.** When an uncertainty has been resolved in a subsequent period, the explanatory paragraph<sup>4</sup> should be removed, and any effects of the uncertainty should be recorded in the period of resolution.

**19.123** An example of a report with an explanatory paragraph (following the opinion paragraph) describing an uncertainty is shown in section 19.612.

**19.124 Going-Concern Uncertainties.** SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU 341), discusses the auditor's responsibilities for considering the entity's ability to continue as a going concern. If the auditor concludes that there is substantial doubt about the entity's ability to continue as a going concern, the situation should be described in an explanatory paragraph, following the opinion paragraph. The explanatory paragraph should describe the principal events and conditions related to the going-concern uncertainty, their possible effects on the financial statements, management's plans for corrective actions, and the auditor's conclusion that substantial doubt exists. SAS No. 64, *Omnibus Statement on Auditing Standards*, paragraph 1 (AU 341.12), imposes the additional requirement that the explanatory paragraph include the terms "substantial doubt" and "going concern." An example of a report with an explanatory paragraph for a going concern is shown in section 19.613.

**19.125** If financial statement disclosures about the uncertainty are inadequate, a departure from GAAP exists, and either a qualified or adverse opinion may be necessary.

## **19.200 REPORT BASED ON WORK OF OTHER AUDITORS**

**19.201** Before deciding to use the work and reports of other auditors who have audited the financial statements of one or more subsidiaries, divisions, or components of financial statements, the auditor must first conclude that he or she is the "principal auditor." Merely auditing the parent company or the home office does not necessarily qualify the auditor as the principal auditor. The auditor should consider the materiality of the portion of the financial statements he or she has audited compared to the portion audited by other auditors, his or her knowledge of the overall financial statements, and the importance of the components audited in relation to the entity's entire business.

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<sup>4</sup> As this Manual went to press, the Auditing Standards Board had issued an Exposure Draft of a proposed Amendment to Statement on Auditing Standards No. 58, *Reports on Audited Financial Statements*, that would eliminate the required uncertainties paragraph in the auditor's report, if the uncertainties are adequately disclosed in the notes to the financial statements. Auditors should ascertain the status of this pronouncement (by calling AICPA Technical Information Hotline at (800) TO-AICPA) before adding an uncertainties explanatory paragraph to an auditor's report.

**19.202** Once the auditor has concluded that he or she may serve as the principal auditor, the next step is to decide whether the auditor's report should refer to the other auditor's work.

#### **Decision to Refer to Other Auditor's Work**

**19.203** If the auditor decides to refer to the other auditor's work, the standard auditor's report should indicate, in the introductory, scope, and opinion paragraphs, the division of responsibility. Generally this is accomplished by stating the dollar amounts or the percentages of total assets and revenues audited by the other auditor. In most cases, the other auditor is not named in the principal auditor's report. However, if the other auditor is named, it should be done only with the other auditor's permission and the other auditor's report should be presented with the principal auditor's report. Section 19.205 describes certain procedures the auditor should follow when referring to another auditor's work.

#### **Decision Not to Refer to Other Auditor's Work**

**19.204** SAS No. 1 (AU 543) establishes guidance for relying on the work of the other auditors. Obviously, if the principal auditor decides not to refer to the other auditor's work or report, he or she must take responsibility for the work done by the other auditor. In addition to the procedures discussed in section 19.205, the principal auditor should also consider visiting the other auditor, discussing the procedures followed and the results, and reviewing the other auditor's audit programs and working papers.

#### **Procedures for Both Methods**

**19.205** Regardless of whether the principal auditor refers to the other auditor, SAS No. 1 (AU 543) requires the principal auditor to—

- Inquire about the other auditor's professional reputation.
- Obtain a written representation from the other auditor that he or she is independent.
- Ascertain through communication with the other auditor that—
  - He or she is aware that the financial statements audited by the other auditor will be included in the financial statements to be audited by the principal auditor.<sup>5</sup>
  - He or she is familiar with U.S. GAAP and GAAS and will conduct the audit and report accordingly.
  - He or she has knowledge of the relevant financial reporting requirements for statements and schedules to be filed with regulatory agencies.<sup>5</sup>
  - A review will be made of matters affecting elimination of intercompany transactions and accounts and uniformity of accounting practices.

**19.206** Section 19.614 shows a reporting example appropriate for situations in which the principal auditor does not rely on the other auditor's work.

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<sup>5</sup> These procedures are generally not required if the principal auditor already knows of the other auditor's reputation and the other auditor's primary place of practice is the U.S.

## **19.300 REPORTING ON COMPARATIVE FINANCIAL STATEMENTS**

### **Prior-Period Audit Performed by Predecessor**

**19.301** When prior periods have been audited by a predecessor auditor, the predecessor may reissue his or her report with the comparative financial statements. A predecessor's reissuance requires that he or she read the current comparative financial statements, inquire of the continuing auditor concerning facts that may affect the prior-period report, and obtain a representation letter from the continuing auditor concerning any relevant information affecting the prior-period financial statements.

**19.302** If the predecessor declines to reissue his or her report, the successor may report on the current-period financial statements and refer to the predecessor's report on the prior-period statements. Sections 19.615, 19.616, and 19.617 illustrate such reports.

### **Reporting on Audited and Unaudited Financial Statements in Comparative Form**

**19.303** When audited financial statements are presented in comparative form with prior-period financial statements of a nonpublic entity that were compiled or reviewed, the auditor should either (1) reissue the compilation or review report or (2) include a separate paragraph in the current year's report that describes his or her responsibility for the prior-period financial statements. Reissuing the prior-period compilation or review report requires that the auditor to present the prior-period report in its entirety, using the original report date. Regardless of which alternative is chosen, the auditor should consider whether the prior-period compilation or review report is still appropriate in light of information he or she becomes aware of during the current year's audit.

**19.304** As a practical matter, it is generally easier to add the separate paragraph to the current year's auditor's report. This paragraph should include—

- A statement of the service performed in the prior period.
- The date of the prior-period report.
- A description of any modifications of the report.
- A statement that the service was less in scope than an audit and does not provide a basis for expressing an opinion on the financial statements taken as a whole.

**19.305** Sections 19.618 and 19.619 illustrate examples of reports on comparative financial statements with the current period audited and the prior period compiled or reviewed.

## **19.400 REPORTING ON SUPPLEMENTARY INFORMATION**

**19.401** Supplementary information includes detailed schedules of other data that are not necessary for a fair presentation of the basic financial statements. Whenever supplementary information is included in an auditor-submitted document, the degree of responsibility, if any, the auditor is taking for that information must be indicated. The auditor may either prepare a separate report on the supplementary information or report on the supplementary information in a separate paragraph in the report on the basic financial



statements. If a separate report is issued, it should be on the firm's letterhead and be signed. The report date should be the same as the date of the report on the basic financial statements.

**19.402** Reports on supplementary information should express or disclaim audit assurance. The extent and results of testing of supplementary information will determine the firm's responsibility in each circumstance. Illustrated in sections 19.620-19.623 are the separate paragraphs that would be added, following the opinion paragraph, to the auditor's report on the basic financial statements. If a separate report on the supplementary information is issued, the first sentence should refer to the report on the basic financial statements.

**19.403 Common Interest Realty Associations (CIRA).** The AICPA Audit and Accounting Guide, *Audits of Common Interest Realty Associations*, establishes a unique requirement for financial statements of CIRAs — required supplementary information. That information, which is not considered part of the basic financial statements, includes estimates of current or future costs of major repairs and replacements, estimates of the remaining useful lives of certain components, and amounts of accumulated funds.

**19.404** If the CIRA financial statements are not accompanied by the required supplementary information, the report shown in section 19.624 should be issued.

## **19.500 OTHER REPORTING SITUATIONS**

### **Reporting on a Single Statement**

**19.501** In certain circumstances, auditors may accept engagements to audit a single financial statement. Generally these engagements, called "limited reporting engagements," are a result of the client needing a single financial statement to fulfill a contractual requirement, such as a retail entity that must provide its landlord with an audited income statement for purposes of calculating rent. Also, entities that have never been audited often request an audit of the balance sheet only for the first year, with the intention of having audits of the complete set of financial statements in the future. This type of engagement is generally appropriate as long as the auditor is satisfied that there is a legitimate reason for the limited engagement, and provided there are no restrictions on access to information underlying the financial statements or on the scope of the procedures to be performed. In such engagements, the auditor can express an unqualified opinion on the financial statement he or she was engaged to audit. Section 19.625 illustrates this type of report. If the other financial statements are presented, the auditor should issue a disclaimer of opinion on those statements. Section 19.626 illustrates this type of report.

### **Relying on the Work of a Specialist**

**19.502** The firm may engage specialists to perform certain work supporting representations in the financial statements. If a review of the specialist's work finds it satisfactory, and if no report modification is made because of the specialist's findings, SAS No. 73, *Using the Work of a Specialist*, prohibits any reference to the specialist's work.

**19.503** If the specialist's work is not adequate to support the financial statement representations, a qualification or disclaimer of opinion because of a scope limitation may be required by SAS No. 73 (AU 336.10). Findings of the specialist that indicate the financial statements are not in accordance with GAAP may require a qualified or adverse opinion.

## **Lack of Independence**

**19.504** Whenever the firm is not independent with respect to a public entity whose financial statements have been audited, a disclaimer of opinion should be issued. For nonpublic entities, the firm may issue a compilation report that includes a statement that the firm is not independent. Whenever the firm is not independent with respect to a public entity whose financial statements have been audited, a disclaimer of opinion should be issued. For nonpublic entities, the firm should issue a compilation report that includes a statement that the firm is not independent. Section 19.627 illustrates a disclaimer of opinion due to a lack of independence.

## **Emphasizing a Matter in an Unqualified Opinion**

**19.505** Occasionally, the firm may express an unqualified opinion, but wishes to call attention to a material matter or circumstance, such as—

- A material accounting principle change to be made in the future.
- Current-period accounting estimate changes that materially affect comparability with prior periods.
- A significant, unusual subsequent event.
- Significant related-party transactions.

**19.506** Illustrated in section 19.628 is an auditor's report that includes an emphasis-of-a-matter paragraph.

## **Updated Opinion Differs From Previous Opinion**

**19.507** When preparing a report on comparative financial statements, the auditor should consider whether any circumstances or events have come to his or her attention in the current year's audit that could affect his or her opinion on the prior year's financial statements. For example, if a qualified opinion was expressed on the prior year's financial statements due to a departure from GAAP, and in the current year the departure was corrected and the financial statements restated, an unqualified opinion would be issued on the restated financial statements.

**19.508** When the updated opinion differs from the original opinion, the reasons for the differing opinions should be disclosed in a separate explanatory paragraph, preceding the opinion paragraph. The explanatory paragraph should disclose the date of the original report, the type of opinion previously expressed, the circumstances or events that caused the auditor to express a different opinion, and the fact that the updated opinion is different from the one previously issued.

**19.509** Illustrated in section 19.629 is a report example that includes explanatory paragraphs describing how the updated opinion differs from the previous opinion.



### **Reissuance of Audit Reports as Predecessors**

**19.510** If the firm is asked by a former client to reissue its report on prior-period financial statements, the firm should inform the client of the procedures necessary to comply with that request. If the client agrees to perform these procedures and pay the fee for these services, the firm would ordinarily agree to reissue the report.

**19.511** Before reissuing a report, the firm should consider whether the previous opinion on those prior-period statements is still appropriate. Differences in the current form and presentation of the financial statements for the prior period, or the possibility of material subsequent events affecting those financial statements, could make the previous opinion inappropriate. The firm should perform at least the following procedures:

1. Read the financial statements of the current period.
2. Compare the prior-period financial statements with the financial statements to be presented in comparative format by the successor.
3. Obtain a letter of representation from the successor auditor. The successor should represent that his or her audit has not revealed any matters that may have a material effect on the prior-period financial statements.

**19.512** If the firm reissues its report without change, the previous report date should be used. If the financial statements or the report of the prior period are revised, the report should be dual dated in respect to the event or matter causing the revision. There should be no reference to the report or the work of the successor auditor.

### **Reissuance of the Independent Auditor's Report Subsequent to the Date of the Original Issue**

**19.513** Occasionally the firm may be requested by a client to furnish additional copies of a previously issued report. Approval of the engagement partner is necessary to reissue a previously issued report. Upon such reissue, the partner should prepare a memo stating the reasons for the reissue of additional copies and that he or she is not aware of any circumstances occurring subsequent to the original report date that would require adjustment to or disclosure in the financial statements.

**19.514** Use of the original report date removes any implication that records, transactions, or events after that date have been audited or reviewed. Although the firm has no responsibility to make further investigation or inquiry as to subsequent events, the engagement partner should consider a brief discussion with the client's chief financial or executive officer before reissuing the report.

### **Subsequent Discovery of Facts Existing at Report Date**

**19.515** Although the auditor has no obligation to make any continuing inquiries or perform other procedures after issuance of the report, the auditor may become aware of information that affects the financial statements previously reported on. When the auditor becomes aware of such information, the auditor should determine the reliability of the information and whether such information existed at the date of the report. The engagement partner should make inquiries of client management in this regard.

**19.516** If (1) the information is reliable and did exist at the date of the report, (2) the report would have been affected if the information had been known at the report date, and (3) there are persons relying on the financial statements who would attach importance to the information, the auditor should take action to prevent future reliance on the report. If the engagement partner concludes that action should be taken to prevent future reliance on the report, he or she should advise the client to make appropriate disclosure of the newly discovered facts and their impact on the financial statements to the persons known to be, or likely to be, relying on the financial statements and related report. Disclosures should be made in one of the following ways:

- If the effects of subsequent facts can be promptly determined, disclosure should include reissuing revised financial statements and a revised report. The reasons for the revision usually should be described in a note to the financial statements and referred to in the report.
- If the current financial statements have not been released, appropriate disclosure of the revision of the prior-period financial statements can be included therein.
- When the effects of subsequent facts cannot be readily determined, revisions of financial statements and reports may be delayed. In this case, persons known to be, or likely to be, relying on the financial statements should be notified by the client that the financial statements and related reports should not be relied on, and that revised financial statements and report will be forthcoming.

**19.517** If the client refuses to make the disclosures discussed above, the firm should contact legal counsel. The engagement partner should also notify all members of the board of directors of such refusal and that the firm will take the following steps to prevent future reliance on its report:

- Notify the client that the auditor's report must no longer be associated with the financial statements.
- Notify any applicable regulatory agencies that the report should no longer be relied upon.
- Notify each person known to be relying on the financial statements that the report should no longer be relied upon.

**19.518** If investigation of the subsequently discovered information is satisfactory, and it is determined that the information is reliable, the notifications in section 19.517 should include a description of the effects of the information on the financial statements. If the client has not cooperated and, as a result, the auditor has been unable to conduct a satisfactory investigation, the auditor does not need to indicate the details of the information. Instead, the auditor should indicate that the report must not longer be relied upon nor should the auditor be associated with the financial statements.

## **19.600 SAMPLE AUDITOR'S REPORTS**

Sections 19.601–19.629 present sample auditor's reports for various reporting situations. (See also section 19.103 for the Audit Reporting Summary.)

**19.601 Single Period Financial Statements**

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**Independent Auditor's Report**

We have audited the accompanying balance sheet of XYZ Company, Inc. as of December 31, 19X, and the related statements of earnings, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Company, Inc. as of December 31, 19X, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.



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**19.602 Comparative Financial Statements**  

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**Independent Auditor's Report**

We have audited the accompanying balance sheets of XYZ Company, Inc. as of December 31, 19X and 19W, and the related statements of earnings, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

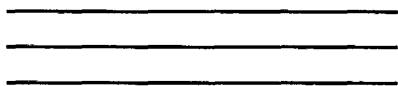
We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence 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.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Company, Inc. as of December 31, 19X and 19W, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.





**19.603 Qualified Opinion — Scope Limitation**



**Independent Auditor's Report**

We have audited the accompanying balance sheets of XYZ Company, Inc. as of December 31, 19X and 19W, and the related statements of earnings, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as discussed in the following paragraph, we conducted our audits in accordance with 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.

We were unable to obtain audited financial statements supporting the Company's investment in a foreign affiliate stated at \$\_\_\_ and \$\_\_\_ at December 31, 19X and 19W, respectively, or its equity in earnings of that affiliate of \$\_\_\_ and \$\_\_\_, which is included in net earnings for the years then ended as described in Note X to the financial statements; nor were we able to satisfy ourselves as to the carrying value of the investment in the foreign affiliate or the equity in its earnings by other auditing procedures.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding the foreign affiliate investment and earnings, the financial statements referred to in the first paragraph present fairly, in all material respects, the financial position of XYZ Company, Inc. as of December 31, 19X and 19W, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.



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**19.604 Disclaimer of Opinion — Scope Limitation**

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**Independent Auditor's Report**

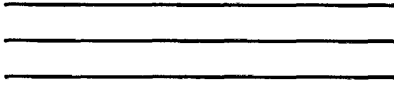
We were engaged to audit the accompanying balance sheets of XYZ Company, Inc. as of December 31, 19X and 19W, and the related statements of earnings, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management.

The Company did not make a count of its physical inventory in 19X or 19W, stated in the accompanying financial statements at \$\_\_\_\_ as of December 31, 19X, and at \$\_\_\_\_ as of December 31, 19W. Further, evidence supporting the cost of property and equipment acquired prior to December 31, 19W, is no longer available. The Company's records do not permit the application of other auditing procedures to inventories or property and equipment.

Since the Company did not take physical inventories and we were not able to apply other auditing procedures to satisfy ourselves as to inventory quantities and the cost of property and equipment, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on these financial statements.





**19.605 First-Year Audit — Beginning Balances Not Audited****Independent Auditor's Report**

We have audited the accompanying balance sheet of XYZ Company, Inc. as of December 31, 19X, and were engaged to audit the related statements of earnings, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

Except as discussed in the following paragraph, we conducted our 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 audit provides a reasonable basis for our opinion.

We did not observe the taking of the physical inventory as of December 31, 19W, since that date was prior to our appointment as auditors for the Company, and we were unable to satisfy ourselves regarding inventory quantities by means of other auditing procedures. Inventory amounts as of December 31, 19W, enter into the determination of results of operations and cash flows for the year ended December 31, 19X. Therefore, we are unable to express, and do not express, an opinion on the accompanying statements of earnings, retained earnings, and cash flows for the year ended December 31, 19X.

In our opinion, the accompanying balance sheet presents fairly the financial position XYZ Company, Inc. as of December 31, 19X, in conformity with generally accepted accounting principles.



**19.606 Qualified Opinion — Departure From GAAP**

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Independent Auditor's Report

We have audited the accompanying balance sheets of XYZ Company, Inc. as of December 31, 19X and 19W, and the related statements of earnings, retained earnings, and cash flows for the years then ended. The 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 Company has excluded, from property and long-term debt in the accompanying balance sheets, certain lease obligations that, in our opinion, should be capitalized in order to conform with generally accepted accounting principles. If these lease obligations were capitalized, property would be increased by \$\_\_\_\_ and \$\_\_\_\_, long-term debt by \$\_\_\_\_ and \$\_\_\_\_, and retained earnings by \$\_\_\_\_ and \$\_\_\_\_ as of December 31, 19X and 19W, respectively. Additionally, net earnings would be increased (decreased) by \$\_\_\_\_ and \$\_\_\_\_ and earnings per share would be increased (decreased) by \$.\_\_\_\_ and \$\_\_\_\_, respectively, for the years then ended.

In our opinion, except for the effects of not capitalizing certain lease obligations as discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Company, Inc. as of December 31, 19X and 19W, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.



### 19.607 Adverse Opinion — Departure From GAAP

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#### Independent Auditor's Report

We have audited the accompanying balance sheets of XYZ Company, Inc. as of December 31, 19X and 19W, and the related statements of earnings, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

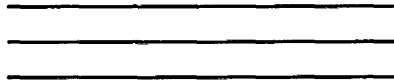
We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence 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 discussed in Note X to the financial statements, the Company carries its property, plant, and equipment accounts at appraisal values, and provides depreciation on the basis of such values. Further, the Company does not provide for deferred taxes with respect to differences between the tax bases of assets and their financial reporting amounts arising because of the use, for income tax purposes, of the accelerated method of depreciation. Generally accepted accounting principles require that property, plant, and equipment be stated at an amount not in excess of cost, reduced by depreciation based on such amount, and that deferred income taxes be provided.

Because of the departures from generally accepted accounting principles identified above, as of December 31, 19X and 19W, inventories have been increased \$\_\_\_\_ and \$\_\_\_\_ by inclusion in manufacturing overhead of depreciation in excess of that based on cost; property, plant, and equipment, less accumulated depreciation, is carried at \$\_\_\_\_ and \$\_\_\_\_ in excess of an amount based on the cost to the Company; and deferred income taxes of \$\_\_\_\_ and \$\_\_\_\_ have not been recorded, resulting in an increase of \$\_\_\_\_ and \$\_\_\_\_ in retained earnings and in stockholders' equity of \$\_\_\_\_ and \$\_\_\_\_, respectively. For the years ended December 31, 19X and 19W, cost of goods sold has been increased \$\_\_\_\_ and \$\_\_\_\_, respectively, because of the effects of the depreciation accounting referred to above, and deferred income taxes of \$\_\_\_\_ and \$\_\_\_\_ have not been provided, resulting in an increase in net earnings of \$\_\_\_\_ and \$\_\_\_\_, respectively.

In our opinion, because of the effects of the matters discussed in the preceding paragraphs, the financial statements referred to above do not present fairly, in conformity with generally accepted accounting principles, the financial position of XYZ Company, Inc. as of December 31, 19X and 19W, or the results of its operations or its cash flows for the years then ended.



**19.608 Qualified Opinion — Inadequate Disclosure****Independent Auditor's Report**

We have audited the accompanying balance sheets of XYZ Company, Inc. as of December 31, 19X and 19W, and the related statements of earnings and retained earnings for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our 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 Company declined to present a statement of cash flows for the years ended December 31, 19X and 19W. Presentation of such statement summarizing the Company's operating, investing, and financing activities is required by generally accepted accounting principles.

In our opinion, except that the omission of a statement of cash flows results in an incomplete presentation as explained in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Company, Inc. as of December 31, 19X and 19W, and the results of its operations for the years then ended in conformity with generally accepted accounting principles.



**19.609 Explanatory Paragraph — Change of GAAP**

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**Independent Auditor's Report**

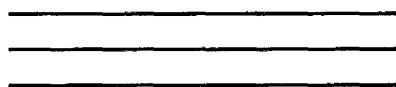
We have audited the accompanying balance sheets of XYZ Company, Inc. as of December 31, 19X and 19W, and the related statements of earnings, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with 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.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Company, Inc. as of December 31, 19X and 19W, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

As discussed in Note X to the financial statements, the Company changed its method of computing depreciation in 19X.



**19.610 Change to an Unacceptable Principle — Qualified Opinion****Independent Auditor's Report**

We have audited the accompanying balance sheets of XYZ Company, Inc. as of December 31, 19X and 19W, and the related statements of earnings, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with 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 A, the Company previously allocated manufacturing overhead to inventories. On January 1, 19X, the Company adopted the method of charging manufacturing overhead to expense when incurred. This practice has understated net earnings for the year ended December 31, 19X, by \$\_\_. This new method is not in accordance with generally accepted accounting principles.

In our opinion, except for the effects of the change in the method of recording manufacturing expenses described in the preceding paragraph, the financial statements referred to in the first paragraph present fairly, in all material respects, the financial position of XYZ Company, Inc. as of December 31, 19X and 19W, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.



**19.611 Client Fails to Provide Reasonable Justification for a Change Between Alternative Acceptable Principles**

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**Independent Auditor's Report**

We have audited the accompanying balance sheets of XYZ Company, Inc. as of December 31, 19X and 19W, and the related statements of earnings, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with 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 disclosed in Note X to the financial statements, the Company adopted, in 19X, the first-in, first-out method of accounting for its inventories, whereas it previously used the last-in, first-out method. Although use of the first-in, first-out method is in conformity with generally accepted accounting principles, in our opinion the Company has not provided reasonable justification for making this change as required by generally accepted accounting principles.

In our opinion, except for the change in accounting principle discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Company, Inc. as of December 31, 19X and 19W, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.



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**19.612 Uncertainty\***

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**Independent Auditor's Report**

We have audited the accompanying balance sheets of XYZ Company, Inc. as of December 31, 19X and 19W, and the related statements of earnings, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with 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.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Company, Inc. as of December 31, 19X and 19W, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

As discussed in Note X to the financial statements, the Company is a defendant in a lawsuit alleging infringement of certain patent rights and claiming royalties and punitive damages. The Company has filed a counteraction, and preliminary hearings and discovery proceedings on both actions are in progress. The ultimate outcome of the litigation cannot presently be determined. Accordingly, no provision for any liability that may result upon adjudication has been made in the accompanying financial statements.

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\* As this Manual went to press, the Auditing Standards Board had issued an Exposure Draft of a proposed Amendment to Statement on Auditing Standards No. 58, *Reports on Audited Financial Statements*, that would eliminate the required uncertainties paragraph in the auditor's report, if the uncertainties are adequately disclosed in the notes to the financial statements. Auditors should ascertain the status of this pronouncement (by calling AICPA Technical Information Hotline at (800) TO-AICPA) before issuing this report.





**19.613 Going-Concern Uncertainty**

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**Independent Auditor's Report**

We have audited the accompanying balance sheets of XYZ Company, Inc. as of December 31, 19X and 19W, and the related statements of earnings, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with 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 statement. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Company, Inc. as of December 31, 19X and 19W, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note X to the financial statements, the Company has suffered recurring losses from operations and has a net capital deficiency that raises substantial doubt about the Company's ability to continue as a going concern. Management's plans in regard to these matters are also described in Note X. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.



**19.614 Report Indicating Divided Responsibility**

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**Independent Auditor's Report**

We have audited the consolidated balance sheets of XYZ Company, Inc. as of December 31, 19X and 19W, and the related consolidated statements of earnings, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of Y Company, a wholly owned subsidiary, which statements reflect total assets of \$\_\_\_ and \$\_\_\_ as of December 31, 19X and 19W, respectively, and total revenues of \$\_\_\_ and \$\_\_\_ for the years then ended. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for Y Company, is based solely on the report of the other auditors.

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 and the report of the other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and the report of the other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of XYZ Company, Inc. as of December 31, 19X and 19W, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.



**19.615 Predecessor Declines Reissue — Prior Period Unqualified**

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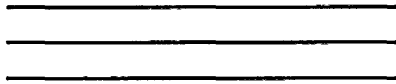
**Independent Auditor's Report**

We have audited the balance sheet of XYZ Company, Inc. as of December 31, 19X, and the related statements of earnings, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of XYZ Company, Inc. as of December 31, 19W, were audited by other auditors whose report dated March 31, 19X, expressed an unqualified opinion on those statements.

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 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 19X financial statements present fairly, in all material respects, the financial position of XYZ Company, Inc. as of December 31, 19X, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.



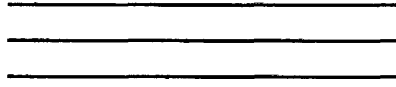
**19.616 Predecessor Declines Reissue — Prior Period Qualified****Independent Auditor's Report**

We have audited the balance sheet of XYZ Company, Inc. as of December 31, 19X, and the related statements of earnings, retained earnings and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of XYZ Company, Inc. as of December 31, 19W, were audited by other auditors whose report, dated March 1, 19X, on those statements was qualified with respect to the outcome of the litigation discussed in Note A to the financial statements.

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 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 19X financial statements present fairly, in all material respects, the financial position of XYZ Company, Inc. as of December 31, 19X, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.



**19.617 Predecessor Declines Reissue — Prior Period Unqualified — Restatement Subsequently Made****Independent Auditor's Report**

We have audited the balance sheet of XYZ Company, Inc. as of December 31, 19X, and the related statements of earnings, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of XYZ Company, Inc. as of December 31, 19W, were audited by other auditors whose report, dated March 1, 19X, on those statements was qualified because the Company did not capitalize lease obligations. As discussed in Note A, the Company has restated its 19W financial statements to conform to generally accepted accounting principles. The other auditors reported on the 19W financial statements prior to the restatement.

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 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 19X financial statements present fairly, in all material respects, the financial position of XYZ Company, Inc. as of December 31, 19X, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

We also audited the adjustments described in Note A that were applied to restate the 19W financial statements. In our opinion, such adjustments are appropriate and have been properly applied.



**19.618 Current Year Audited — Prior Period Reviewed**  

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**Independent Auditor's Report**

We have audited the accompanying balance sheet of XYZ Company, Inc. as of December 31, 19X, and the related statements of earnings, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Company, Inc. as of December 31, 19X, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

The 19W financial statements were reviewed by us and our report thereon, dated April 5, 19X, stated we were not aware of any material modifications that should be made to those statements for them to be in conformity with generally accepted accounting principles. However, a review is substantially less in scope than an audit and does not provide a basis for the expression of an opinion on the financial statements taken as a whole.



**19.619 Current Year Audited — Prior Period Compiled**

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**Independent Auditor's Report**

We have audited the accompanying balance sheet of XYZ Company, Inc. as of December 31, 19X, and the related statements of earnings, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Company, Inc. as of December 31, 19X, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

The 19W financial statements were compiled by us and our report thereon, dated April 5, 19X, stated we did not audit or review those financial statements and, accordingly, express no opinion or other form of assurance on them.



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**19.620 Unqualified Report on Supplementary Information**

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**Independent Auditor's Report**

We have audited the accompanying balance sheet of XYZ Company, Inc. as of December 31, 19X, and the related statements of earnings, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Company, Inc. as of December 31, 19X, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplementary information presented on pages x through x is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.





**19.621 Disclaimer on Part of Supplementary Information**

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**Independent Auditor's Report**

We have audited the accompanying balance sheet of XYZ Company, Inc. as of December 31, 19X, and the related statements of earnings, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

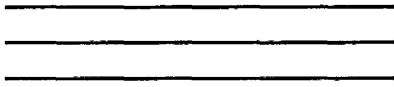
We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Company, Inc. as of December 31, 19X, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information presented on pages x through x is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information, except for that portion marked "unaudited," on which we express no opinion, has been subjected to the auditing procedures applied in the audit of the basic financial statements; and, in our opinion, the information is fairly stated in all material respects in relation to the basic financial statements taken as a whole.



◆ **19.622 Disclaimer on All Supplementary Information**



**Independent Auditor's Report**

We have audited the accompanying balance sheet of XYZ Company, Inc. as of December 31, 19X, and the related statements of earnings, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Company, Inc. as of December 31, 19X, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles. Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information presented on pages x through x is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has not been subjected to the auditing procedures applied in the audit of the basic financial statements, and, accordingly, we express no opinion on it.



**19.623 Report on Basic Financial Statements Qualified — Qualified Opinion on Supplementary Information**

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**Independent Auditor's Report**

We have audited the accompanying balance sheet of XYZ Company, Inc. as of December 31, 19X, and the related statements of earnings, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Company, Inc. as of December 31, 19X, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles. Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information presented on pages x through x is presented for purposes of additional analysis and is not a required part of the basic financial statements. The information has been subjected to the auditing procedures applied in the audit of the basic financial statements, and, in our opinion, except for the effects of [describe effects], such information is fairly stated in all material respects in relation to the basic financial statements taken as a whole.



**19.624 CIRA Financial Statements — Required Supplementary Information Not Included**

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**Independent Auditor's Report**

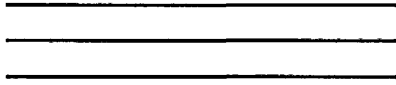
We have audited the accompanying balance sheet of XYZ Association as of December 31, 19X, and the related statements of earnings, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Association's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Association as of December 31, 19X, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

As discussed in Note X, the Association has not estimated the remaining lives and replacement costs of the common property and, therefore, has not presented information about the estimates of future costs of major repairs and replacements that will be required in the future that the American Institute of Certified Public Accountants has determined is required to supplement, although not required to be a part of, the basic financial statements.



**19.625 Report on Balance Sheet — Balance Sheet Only Presented****Independent Auditor's Report**

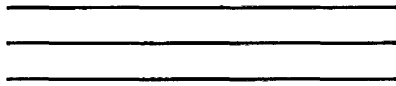
We have audited the accompanying balance sheet of XYZ Company as of December 31, 19X. This financial statement is the responsibility of the Company's management. Our responsibility is to express an opinion on this financial statement based on our audit.

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

In our opinion, the balance sheet referred to above presents fairly, in all material respects, the financial position of XYZ Company as of December 31, 19X, in conformity with generally accepted accounting principles.



◆ **19.626 Report on Balance Sheet — Disclaimer on Other Statements**



**Independent Auditor's Report**

We have audited the accompanying balance sheet of XYZ Company, Inc. as of December 31, 19X. This financial statement is the responsibility of the Company's management. Our responsibility is to express an opinion on this financial statement based on our audit.

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

In our opinion, the balance sheet referred to above presents fairly, in all material respects, the financial position of XYZ Company, Inc. as of December 31, 19X, in conformity with generally accepted accounting principles.

Because we were not engaged to audit the related statements of earnings, retained earnings, and cash flows, we did not extend our auditing procedures to enable us to express, and accordingly we do not express, an opinion on those financial statements.





**19.627 Lack of Independence (Public Companies Only)**

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**Auditor's Report**

We are not independent with respect to XYZ Company, and the accompanying balance sheet as of December 31, 19X, and the related statements of income, retained earnings, and cash flows for the year then ended were not audited by us and, accordingly, we do not express an opinion on them.



**19.628 Emphasis of a Matter**  

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**Independent Auditor's Report**

We have audited the accompanying balance sheets of XYZ Company, Inc. as of December 31, 19X and 19W, and the related statements of earnings, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with 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.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Company, Inc. as of December 31, 19X and 19W, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

As stated in Note A to the financial statements, the Company plans to acquire \$\_\_\_ of new production equipment. The new equipment will be depreciated by accelerated methods of depreciation. Similar equipment currently in use is fully depreciated.





**19.629 Subsequent Restatement of Prior Period to Conform With GAAP**

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**Independent Auditor's Report**

We have audited the accompanying balance sheets of XYZ Company, Inc. as of December 31, 19X and 19W, and the related statements of earnings, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with 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.

In our report dated April 5, 19X, we expressed an opinion that the 19W financial statements did not fairly present financial position, results of operations, and cash flows in conformity with generally accepted accounting principles because of two departures from such principles:

1. The Company carried its property and equipment at fair market values, and provided for depreciation on the basis of such values.
2. The Company did not provide for deferred taxes with respect to differences between the tax bases of assets and liabilities and their financial reporting amounts.

As described in Note A, the Company has restated its 19W financial statements to conform with generally accepted accounting principles. Accordingly, our present opinion on the 19W financial statements, as presented herein, is different from that expressed in the previous report.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Company, Inc. as of December 31, 19X and 19W, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.





## CHAPTER 20

### REPORTING ON COMPILATION AND REVIEW ENGAGEMENTS

#### Table of Contents

<u>Section</u>		<u>Page</u>
20.000	APPLICABILITY	20-3
20.100	ASSOCIATION WITH FINANCIAL STATEMENTS	20-3
20.200	REPORT PREPARATION	20-4
20.202	Letterhead	20-4
20.203	Addressee	20-4
20.205	Salutation	20-4
20.206	Report Signing	20-4
20.207	Report Dating	20-4
20.209	Dual-Dating	20-5
20.211	Level of Service	20-5
20.214	Financial Statement References to Report and Notes	20-6
20.215	Lack of Independence	20-6
20.216	Qualified and Adverse Opinions	20-6
20.300	COMPILATION REPORTS	20-7
20.304	Standard Compilation Report Modified for the Omission of Substantially All Disclosures	20-7
20.306	Standard Compilation Report Modified for Departures From GAAP	20-8

## CHAPTER 20

### REPORTING ON COMPILATION AND REVIEW ENGAGEMENTS

#### Table of Contents (Continued)

<b><u>Section</u></b>		<b><u>Page</u></b>
20.309	Compilation Report — Changed Reference to a Prior-Period Departure From GAAP	20-8
20.310	Comparative Compiled Statements Omitting Substantially All Disclosures	20-8
20.400	REVIEW REPORTS	20-8
20.404	Review Report Modified for Departure From GAAP	20-9
20.407	Review Report — Changed Reference to a Prior-Period GAAP Departure	20-9
20.500	DIFFERENT LEVEL OF SERVICE IN PRIOR PERIOD	20-9
20.501	Lower Level of Service In Current Period	20-9
20.506	Higher Level of Service In Current Period	20-10
20.507	Prior-Period Statements Compiled or Reviewed by Other Accountants	20-10
20.600	REPORTING ON A SINGLE FINANCIAL STATEMENT	20-11
20.700	REPORTING ON COMPILED OR REVIEWED FINANCIAL STATEMENTS CONTAINING UNCERTAINTIES	20-11
20.702	Uncertainty About Ability to Continue As a Going Concern	20-11
20.800	OTHER REPORTING SITUATIONS	20-11
20.801	Reporting on Supplementary Information	20-11
20.803	Reporting on Financial Statements Prepared on An Other Comprehensive Basis of Accounting	20-12
20.804	Accountant's Reports on Specified Elements, Accounts, or Items of a Financial Statement	20-12
20.805	Compilation Report on Financial Statements Prepared on a Prescribed Form	20-12
20.900	SAMPLE COMPILATION AND REVIEW REPORTS	20-13

## CHAPTER 20

### REPORTING ON COMPILATION AND REVIEW ENGAGEMENTS

#### 20.000 APPLICABILITY

**20.001** This Chapter is designed for use on review and compilation engagements governed by Statements on Standards for Accounting and Review Services (SSARS) Nos. 1 through 7. A discussion of the performance requirements for compilation and review engagements is contained in Chapter 4 of this Manual.

#### **Practice Tip:**

On August 4, 1995, the AICPA Accounting and Review Services Committee approved the issuance of an exposure draft of a new SSARS that would provide an exemption from SSARS No. 1 for the assembly of financial statements for internal use only. The new SSARS would require an engagement letter, however, neither an accountant's report nor a legend on the financial statements would be required. The proposed amendment would not preclude an accountant from complying with SSARS No. 1 when he or she submits internal use only financial statements. To obtain the most recent information about this exposure draft, call the AICPA's Technical Information Hotline at 800-862-4272, menu option No. 2.

#### 20.100 ASSOCIATION WITH FINANCIAL STATEMENTS

**20.101** A firm is associated with *historical* financial statements when:

- It consents to the use of its name in other client-prepared documents containing the financial statements.
- It submits financial statements it prepared or assisted in preparing to clients or others, even though the firm's name is not included with the statements.

**20.102** A firm may be associated with historical financial statements during the following engagements:

- Reviews
- Full-disclosures compilations
- Disclosures-omitted compilations

**20.103** Association with *prospective* financial statements is defined in the AICPA's Statement on Standards for Attestation Engagements No. 1, section 200, *Financial Forecasts and Projections* (AT 200), and the AICPA *Guide for Prospective Financial Information*.

## **20.200 REPORT PREPARATION**

**20.201** Firms should develop standard policies and procedures for preparing and issuing reports. The following are some suggested report preparation policies:

### **Letterhead**

**20.202** The report should be presented on firm letterhead for all engagements, including compilations of computer-generated financial statements where possible.

### **Addressee**

**20.203** The report ordinarily should be addressed to the board of directors, stockholders, partners, general partner, proprietor, or to the company whose financial statements are being audited. If the firm was engaged by others, the report should be addressed thereto.

**20.204** The Board of Directors  
XYZ Company, Inc.  
City, State

### **Salutation**

**20.205** A salutation should not be included on the report.

### **Report Signing**

**20.206** The firm name should be manually signed by the engagement partner after completing the Financial Statement Control Form. The words "Certified Public Accountants" should be excluded from the signature if they are part of the firm's letterhead.

### **Report Dating**

**20.207** Compilation and review reports should be dated when all significant procedures have been completed. Because compilation and review engagements are often performed in the firm's offices and field work is not performed, measurement of engagement completion should be related to the in-charge accountant's work. The compilation or review report should be dated when the in-charge has completed all significant procedures, including any resulting from the partner's review.

The date should be presented at the bottom of the page along with the city and state, if not included in firm letterhead, as follows:

**20.208** City, State  
April 5, 19Y

**Dual-Dating**

**20.209** If significant subsequent events are discovered before the report is issued, but after the completion of the engagement, the report should be dual-dated for the subsequent event. Subsequent events affecting previously issued reports will also cause our report to be dual-dated.

**20.210** City, State

February 26, 19Y, except for Note X as to which the date is April 5, 19Y

**Level of Service**

**20.211** The level of service performed and the nature of the report to be issued should be clearly stated in the firm's engagement letter. The letter should be revised for any significant changes from the original understanding with the client, i.e., a step-up or step-down in the level of service.

**20.212** The engagement partner should approve any step-up or step-down in level of service. A step-up in level of service may occur after a revised understanding with the client. A step-down in level of service should occur only after carefully evaluating the reasons for change. The reasons for change also may affect the report on lower levels of service. Limitations in the scope of audits, for example, also may preclude stepping-down to a review or compilation service.

**20.213** The elements of compilation and review reports are:

**Compilation**

State that a compilation has been performed in accordance with Statements on Standards for Accounting and Review Services issued by the AICPA.

State that a compilation is limited to presenting management's representations in the form of financial statements.

State that an audit or review has not been performed and no opinion or assurance is being expressed.

**Review**

State that a review was performed in accordance with Statements on Standards for Accounting and Review Services issued by the AICPA, and that all information is management's representation.

State that a review consists primarily of applying inquiries and analytical procedures to financial data.

State that the scope of a review is less than an audit and no opinion is being expressed.

**Compilation**

No express assurance is included.

Material departures from generally accepted accounting principles (GAAP) should be disclosed in the accountant's report.

**Review**

State that no material modifications are necessary for the statements to conform with GAAP.

Material departures from GAAP should be disclosed in the accountants' report.

**Financial Statement References to Report and Notes**

**20.214** All pages of the financial statements should be referenced to the compilation or review report and to the notes, as follows:

See accountants' compilation (review)  
report and notes to the financial statements.

Each page of the notes to the financial statements also should be referenced to the report.

**Lack of Independence**

**20.215** The firm cannot issue a review report on financial statements of a nonpublic company with respect to which the firm is not independent. A compilation report, however, may be issued with an additional paragraph that states:

We are not independent with respect  
to XYZ Company, Inc.

**Qualified and Adverse Opinions**

**20.216** SSARS No. 1 makes no provision for a qualified or adverse opinion. Limitations by the client of the procedures necessary to issue a review report, or other conditions, will preclude issuing such a report. Reasons for such limitations should be carefully considered because ordinarily they also will preclude issuing a compilation report.

**20.217** The objective of a review service is to provide limited assurance that the financial statements are presented in accordance with GAAP. If departures from such principles are not revised by the client or disclosed in a note, the departures should be disclosed in an additional paragraph of the report, provided such disclosure is sufficient to prevent the financial statements from being misleading. If such disclosure is not adequate, the firm may either issue a compilation report with substantially all disclosures omitted or withdraw from the engagement. In such a situation, however, the departure may also cause compiled



statements to be misleading. See sections 20.904–.906 and 20.927–.929, respectively, for sample compilation and review reports describing the GAAP departure.

## **20.300 COMPILATION REPORTS**

**20.301** Compilation reports are issued in three basic forms:

- The standard report (full-disclosure financial statements).
- The standard report modified for the omission of substantially all disclosures.
- The standard report modified for departures from GAAP.

**20.302** Procedures for a compilation engagement are described in detail in section 4.002 of Chapter 4.

Briefly, a compilation engagement requires:

- An understanding of the client's business and industry.
- Reading the financial statements to see that they are appropriate in form and free from obvious material errors.
- Requesting additional or revised information when the information provided by the client appears to be incorrect, incomplete, or otherwise unsatisfactory.

**20.303** After completing the appropriate engagement checklist and resolving any problems, the standard report on compilation illustrated in section 20.902 can be issued.

### **Standard Compilation Report Modified for the Omission of Substantially All Disclosures**

**20.304** A compilation report can be issued on financial statements that omit substantially all disclosures provided the omission is not intended to mislead users. The report must clearly disclose this omission. Review reports cannot be issued on financial statements that omit substantially all disclosures because all required financial statement disclosures have to be included in the report. A general reference to the omission in a review report is *not* appropriate. If a client insists on omitting substantially all disclosures, the level of service should be changed to a compilation if the auditor determines that the departure is not intended to mislead users.

**20.305** Compilation reports can also be issued for financial statements that contain only selected informative disclosures. Such disclosures should be labeled "Selected Information — Substantially All Disclosures Required By Generally Accepted Accounting Principles Are Not Included." A compilation report stating that substantially all disclosures have been omitted is presented in section 20.903.

### **Standard Compilation Report Modified for Departures From GAAP**

**20.306** If an accountant who is engaged to compile financial statements becomes aware of a material departure from GAAP or OCBOA, he or she has three options: (a) convince the client to revise the financial statements, (b) modify the report to disclose the departure, or (c) withdraw from the engagement. If the financial statements are not revised, the accountant should consider whether modification of the standard report is adequate to disclose the departure. In rare circumstances, withdrawal from the engagement may be necessary.

**20.307** If report modification for the departure is appropriate, the nature of the departure and its effects on the financial statements, if determined, should be included in a separate paragraph. Although not required, whenever feasible the firm should attempt to determine the effects of departures if management has not done so.

**20.308** Sections 20.904–20.906 illustrate sample compilation reports that disclose departures from GAAP.

### **Compilation Report — Changed Reference to a Prior-Period Departure From GAAP**

**20.309** If prior-period compiled statements originally issued with a reference to a departure from GAAP are revised and presented comparatively with the current period compiled statements, the report should state that those prior-period statements have been restated, as illustrated in section 20.907.

### **Comparative Compiled Statements Omitting Substantially All Disclosures**

**20.310** Comparative compiled financial statements can be presented with disclosures or with omission of substantially all disclosures. Both periods, however, must be presented similarly. Compiled financial statements that omit substantially all disclosures can be presented comparatively even though they were previously compiled, reviewed, or audited and included all disclosures. A sample comparative compilation report is presented in section 20.908.

## **20.400 REVIEW REPORTS**

**20.401** Review reports are issued in two basic forms:

- The standard report.
- The standard report modified for departures from GAAP.

**20.402** The procedures for a review engagement are detailed in Chapter 4, section 4.103.

Briefly, a review engagement requires:

- An understanding of the client's business and its industry.

- Making inquiries and performing analytical procedures to offer limited assurance the financial statements are presented in accordance with GAAP.
- Obtaining a client representation letter.

**20.403** After completing the appropriate engagement checklists and resolving any problems, the standard review report presented in section 20.926 can be issued.

#### **Review Report Modified for Departure From GAAP**

**20.404** Departures from GAAP that are not revised should be disclosed in the report provided such disclosures are sufficient to prevent the financial statements from being misleading. If report disclosure is not sufficient, the in-charge should consult with the engagement partner to consider withdrawing from the engagement. The firm's service objective should be, of course, to persuade the client to make any appropriate revisions to the financial statements and related disclosures.

**20.405** If report modification for the departure is appropriate, the nature of the departure, and its effects on the financial statements, if determined, should be included in a separate paragraph. Although not required, whenever feasible the firm should attempt to determine the effects of departures if management has not done so.

**20.406** Sections 20.927–20.929 illustrate review reports modified for a departure from GAAP, including omission of the statement of cash flows.

#### **Review Report — Changed Reference to a Prior-Period GAAP Departure**

**20.407** If prior-period reviewed statements, originally issued with a reference to a departure from GAAP, are revised and presented comparatively with current reviewed statements, the following report should state that the prior-period statements were restated. A sample report is presented in section 20.930.

### **20.500 DIFFERENT LEVEL OF SERVICE IN PRIOR PERIOD**

#### **Lower Level of Service In Current Period**

**20.501** If the level of service in the current period is lower than that of the prior period, the accountant is not required to update his or her prior-period report. Instead, the accountant should either (1) reissue his or her report on the prior-period financial statements or (2) include a separate paragraph in the current-period report that describes the responsibility assumed for the prior-period financial statements.

**20.502** A *reissued* report is essentially a duplicate of the original report. A reissued report bears the same date as the original report and usually repeats the conclusions presented in the original report. However, a reissued report may need to be revised if the accountant has become aware of specific events that might affect the prior-period financial statements.

**20.503** If the accountant elects to reissue his or her report on the prior-period financial statements, that report may be presented separately from the current-period report or may be combined with it. When the accountant combines the prior-period report with the current-period report, the combined report should state that the accountant has not performed any procedures in connection with the previous engagement after the date of the previous report.

**20.504** If the accountant elects to include a separate paragraph in the current-period report that describes his or her responsibility for the prior-period financial statements, that paragraph should state —

- The date of the prior-period financial statements.
- The service provided in the prior period.
- The date of the accountant's previous report.
- The conclusions in the previous report.
- That the accountant has not performed any procedures in connection with the prior engagement subsequent to the date of his or her report on that engagement.

**20.505** Sample reports are presented in sections 20.909–.910 and 20.931. Any modifications to the prior period's report should be explained in an additional paragraph.

#### **Higher Level of Service In Current Period**

**20.506** Prior-period statements that were subjected to a level of service lower than the current period should be updated. An updated report expresses new conclusions on the prior-period statements under the current report date. The nature of the original engagement is not changed, but instead, the report takes into account events and circumstances occurring since the issue of the original report. A sample report is presented in section 20.932.

#### **Prior-Period Statements Compiled or Reviewed by Other Accountants**

**20.507** For comparative presentations, when prior-period statements were compiled or reviewed by other accountants, the predecessor may reissue his or her report, the successor may perform a compilation, review, or audit of those prior-period statements and issue a report on those periods, or the successor's report may refer to the predecessor's report.

**20.508** When the predecessor reissues his or her report, the predecessor must review the current presentation of the statements, compare the prior-period financial statements with those previously issued and the current financial statements, and obtain a letter from the successor accountant as to any facts of which he or she is aware that may affect the prior-period statements.

**20.509** Sample reports that illustrate the successor accountant's reference to the predecessor's report are presented in sections 20.911 and 20.933.

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**20.600 REPORTING ON A SINGLE FINANCIAL STATEMENT**

**20.601** A compilation or review report may be issued on one basic financial statement and not on the others provided the accountant's access to information underlying the basic financial statements is not limited and sufficient procedures are accomplished. Chapter 10 includes work programs and checklists that must be completed for the statement being compiled or reviewed. Sample reports on a single financial statement are presented in sections 20.912 and 20.934.

**20.700 REPORTING ON COMPILED OR REVIEWED FINANCIAL STATEMENTS CONTAINING UNCERTAINTIES**

**20.701** Financial statements presented in accordance with GAAP should disclose information about significant uncertainties affecting the client's financial statements, including those related to the client's ability to continue as a going concern. As long as the accountant believes that disclosures about uncertainties are adequate, there is no need to modify the compilation or review report. The accountant, however, may decide to add a paragraph to his or her report to emphasize those uncertainties.

**Uncertainty About Ability to Continue As a Going Concern**

**20.702** A special type of significant uncertainty occurs when the accountant becomes aware of matters that may adversely affect the client's ability to continue as a going concern. Conditions that might cause the accountant to question whether there is a significant uncertainty about the client's ability to continue as a going concern in matters such as negative cash flows from operations, defaults on loan agreements, adverse financial ratios, work stoppages, and legal or regulatory proceedings.

**20.703** The accountant's performance and reporting obligation is the same for a going-concern uncertainty as for other uncertainties — the adequacy of financial statement disclosures must be considered.<sup>1</sup> Provided the financial statements appropriately disclose the uncertainty, the accountant is not required to modify his or her report. The accountant may, however, elect to add a separate paragraph to his or her report that discusses a going-concern uncertainty.

**20.800 OTHER REPORTING SITUATIONS****Reporting on Supplementary Information**

**20.801** When supplementary information accompanies compiled or reviewed financial statements in an accountant-submitted document, the accountant must indicate the degree of responsibility he or she is taking for such information. Sample reports, that include appropriate wording, are presented in sections 20.913, and 20.935–.936.

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<sup>1</sup> Footnote 18 of SSARS No. 1 (AR 100.40, fn. 18) states that in evaluating the adequacy of the disclosure of going-concern uncertainties, the accountant should look to the guidance provided in paragraphs 10 and 11 of SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*.

**20.802** At the bottom of, and always on the same line of each page of, the basic financial statements and the supplementary information there should be a specific reference, as follows:

See accountants' compilation (review) report.

### **Reporting on Financial Statements Prepared on An Other Comprehensive Basis of Accounting**

**20.803** An accountant may be engaged to compile or review the financial statements of an entity that prepares its statements on some other basis of accounting (OCBOA). If an accountant "submits" an OCBOA financial statement to his or her client or others, the accountant should comply with the requirements of SSARS — the accountant must at a minimum compile the financial statements. Sample compilation and review reports for OCBOA engagements are presented in sections 20.914–.915 and 20.937–.938.

### **Accountant's Reports on Specified Elements, Accounts, or Items of a Financial Statement**

**20.804** Accountants may be engaged to report on various special-purpose financial presentations of nonpublic entities that do not meet the definition of GAAP or OCBOA financial statements. For example, an accountant may be engaged to compile or review a separate presentation of a specified element, account, or item of a financial statement or to compile or review a financial statement prepared under a contractual or regulatory basis of accounting. Section 4.714 in Chapter 4 discusses the performance requirements of such an engagement. Sample compilation and review reports on specified elements, accounts, or items of a financial statement, and on financial presentations pursuant to contractual agreements are presented in sections 20.916–.917 and 20.939.

### **Compilation Report on Financial Statements Prepared on a Prescribed Form**

**20.805** An accountant may be engaged to compile a financial statement included in a prescribed form. Because these forms are designed to meet the specific requirements of certain entities that use them, they often call for departures from GAAP. Under SSARS No. 1, GAAP departures must be disclosed in the accountant's compilation report. However, SSARS No. 3, *Compilation Reports on Financial Statements Included in Certain Prescribed Forms*, provides an alternative form of compilation report on financial statements included in prescribed forms. Section 4.708 in Chapter 4 discusses the SSARS No. 3 requirements. A sample compilation report for a prescribed-form engagement is presented in section 20.918.

## 20.900 SAMPLE COMPILATION AND REVIEW REPORTS

20.901 The reports on the following pages illustrate the reports for various compilation and review engagements.

<u>Section</u>	<u>Description</u>	<u>Page</u>
<b>Compilation Reports</b>		
20.902	Standard Compilation Report	20-15
20.903	Substantially All Disclosures Omitted	20-16
20.904	Departure From GAAP With Effect Determined	20-17
20.905	Departure From GAAP With Effect Not Determined	20-18
20.906	Omission of Statement of Cash Flows	20-19
20.907	Changed Reference to a Prior-Period Departure from GAAP	20-20
20.908	Comparative Financial Statements — Disclosure Omitted	20-21
20.909	Compiled Current Period — Reviewed Prior Period	20-22
20.910	Compiled Current Period — Audited Prior Period	20-23
20.911	Prior Period Compiled by Other Accountants	20-24
20.912	Balance Sheet Only	20-25
20.913	Supplementary Information Included	20-26
20.914	Income Tax Basis Financial Statements	20-27
20.915	Cash Basis Financial Statements	20-28
20.916	Report on Specified Elements, Accounts, or Items of a Financial Statement	20-29
20.917	Report on Special-Purpose Financial Presentation Pursuant to An Acquisition Agreement That Results in a Presentation That Is Not in Conformity With GAAP or OCBOA	20-30
20.918	Prescribed Form	20-31

[Next Section is 20.926]



<u>Section</u>	<u>Description</u>	<u>Page</u>
<b>Review Reports</b>		
20.926	Standard Review Report	20-32
20.927	GAAP Departure With Effect Determined	20-33
20.928	GAAP Departure With Effect Not Determined	20-34
20.929	Statement of Cash Flows Omitted	20-35
20.930	Changed Reference to a Prior-Period Departure From GAAP	20-36
20.931	Reviewed Current Period — Audited Prior Period	20-37
20.932	Reviewed Current Period — Compiled Prior Period	20-38
20.933	Prior Period Reviewed by Other Accountants	20-39
20.934	Balance Sheet Only	20-40
20.935	Supplementary Information Subjected to Review Procedures	20-41
20.936	Supplementary Information Not Subjected to Review Procedures	20-42
20.937	Income Tax Basis Financial Statements	20-43
20.938	Cash Basis Financial Statements	20-44
20.939	Report on Special-Purpose Financial Presentation Pursuant to An Acquisition Agreement That Results in a Presentation That Is Not in Conformity With GAAP or OCBOA	20-45



**20.902 Standard Compilation Report**

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I (We) have compiled the accompanying balance sheet of XYZ Company, Inc. as of December 31, 19X, and the related statements of income and retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

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

(Firm's signature)

\_\_\_\_\_ [Report Date]

**Note:** This reporting guidance assumes that a combined statement of income and retained earnings is presented. If a separate statement of retained earnings is presented, the report should be worded as follows:

I (We) have compiled the accompanying balance sheet of XYZ Company, Inc. as of December 31, 19X and the related statements of income, retained earnings, and cash flows for the year then ended,...



**20.903 Compilation Report — Substantially All Disclosures Omitted**

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I (We) have compiled the accompanying balance sheet of XYZ Company, Inc. as of December 31, 19X, and the related statements of income and retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

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

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

(Firm's signature)

\_\_\_\_\_ [Report Date]



**20.904 Compilation Report — Departure From GAAP With Effect Determined**

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I (We) have compiled the accompanying balance sheet of XYZ Company, Inc. as of December 31, 19X, and the related statements of income and retained earnings and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of financial statements information that is the representation of management. I (We) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them. However, we did become aware of a departure from generally accepted accounting principles that is described in the following paragraph.

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

(Firm's signature)

\_\_\_\_\_ [Report Date]





**20.905 Compilation Report — Departure From GAAP With Effect Not Determined**

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\_\_\_\_\_

I (We) have compiled the accompanying balance sheet of XYZ Company, Inc. as of December 31, 19X, and the related statements of income and retained earnings and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

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

As disclosed in Note X to the financial statements, generally accepted accounting principles require that inventory cost consist of material, labor, and overhead. Management has informed me (us) that the inventory cost of finished goods and work in process is stated in the accompanying financial statements at material and labor cost only, and the effect of this departure from generally accepted accounting principles on financial position, results of operations, and cash flows has not been determined.

(Firm's signature)

\_\_\_\_\_ [Report Date]



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**20.906 Compilation Report — Omission of Statement of Cash Flows**

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I (We) have compiled the accompanying balance sheet of XYZ Company, Inc. as of December 31, 19X, and the related statements of income and retained earnings for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

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

A statement of cash flows for the year ended December 31, 19X, has not been presented. Generally accepted accounting principles require that such a statement be presented when financial statements purport to present financial position and results of operations.

(Firm's signature)

\_\_\_\_\_ [Report Date]





**20.907 Compilation Report — Changed Reference to a Prior-Period Departure From GAAP**

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I (We) have compiled the accompanying balance sheets of XYZ Company, Inc. as of December 31, 19X and 19W, and the related statements of income and retained earnings and cash flows for the years then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

In my (our) previous compilation report dated April 5, 19X, on the 19W financial statements, I (we) referred to a departure from generally accepted accounting principles because the company carried its land at fair market value. However, as described in Note X, the Company has restated its 19W financial statements to reflect its land at cost in accordance with generally accepted accounting principles.

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

(Firm's signature)

\_\_\_\_\_ [Report Date]



**20.908 Comparative Financial Statements — Disclosures Omitted**

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I (We) have compiled the accompanying balance sheet of XYZ Company, Inc. as of December 31, 19X and 19W, and the related statements of income and retained earnings and cash flows for the years then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

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

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

The accompanying 19W financial statements were compiled by me (us) from financial statements that did not omit substantially all of the disclosures required by generally accepted accounting principles. Such financial statements were previously reviewed as indicated in my (our) report dated April 5, 19X.

(Firm's signature)

\_\_\_\_\_ [Report Date]





**20.909 Compiled Current Period — Reviewed Prior Period**

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I (We) have compiled the accompanying balance sheet of XYZ Company, Inc. as of December 31, 19X, and the related statements of income, retained earnings and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of financial statements information that is the representation of management. I did (We have) not audited or reviewed the accompanying 19X financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

The accompanying 19W financial statements of XYZ Company, Inc. were previously reviewed by me (us) in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in the 19W financial statements is the representation of the management of XYZ Company, Inc.

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

Based on my (our) review, I was (we were) not aware of any material modifications that should have been made to the accompanying 19W financial statements in order for them to be in conformity with generally accepted accounting principles. I (We) have not performed any review procedures after April 5, 19X, the date of my (our) report on the accompanying 19W financial statements.

(Firm's signature)

\_\_\_\_\_ [Report Date]





◆ \_\_\_\_\_  
**20.910 Compiled Current Period — Audited Prior Period**

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I (We) have compiled the accompanying balance sheet of XYZ Company, Inc. as of December 31, 19X, and the related statements of income and retained earnings and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of financial statements information that is the representation of management. I did (We have) not audited or reviewed the accompanying 19X financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

The financial statements for the year ended December 31, 19W, were audited by me (us) and I (we) expressed an unqualified opinion on them in my (our) report dated April 5, 19X, but I (we) have not performed any auditing procedures since that date.

(Firm's signature)

\_\_\_\_\_ [Report Date]



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**20.911 Compiled Statements — Prior Period Compiled by Other Accountants**

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I (We) have compiled the accompanying balance sheet of XYZ Company, Inc. as of December 31, 19X, and the related statements of income and retained earnings and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of financial statements information that is the representation of management. I (We) have not audited or reviewed the accompanying 19X financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

The 19W financial statements of XYZ Company, Inc. were compiled by other accountants whose report dated April 5, 19X, stated that they did not express an opinion or any other form of assurance on those statements.

(Firm's signature)

\_\_\_\_\_ [Report Date]



◆ \_\_\_\_\_  
**20.912 Compilation Report — Balance Sheet Only**

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I (We) have compiled the accompanying balance sheet of XYZ Company, Inc. as of December 31, 19X, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

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

(Firm's signature)

\_\_\_\_\_ [Report Date]





**20.913 Compilation Report — Supplementary Information Included**

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I (We) have compiled the accompanying balance sheet of XYZ Company as of December 31, 19X and the related statements of income, retained earnings, and cash flows for the year then ended, and the accompanying schedules of cost of goods sold and of selling, general, and administrative expenses, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

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

(Firm's signature)

\_\_\_\_\_ [Report Date]



**29.914 Compilation Report — Income Tax Basis Financial Statements**

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I (We) have compiled the accompanying statement of assets and liabilities—income tax basis of XYZ Company, Inc. as of December 31, 19X, and the related statement(s) of revenue and expenses (and retained earnings)—income tax basis for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

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

(Firm's signature)

\_\_\_\_\_ [Report Date]



**20.915 Compilation Report — Cash Basis Financial Statements**

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I (We) have compiled the accompanying statement of assets and liabilities—cash basis of ABC Company, Inc. as of December 31, 19X, and the related statement(s) of revenue and expenses (and retained earnings)—cash basis for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

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

(Firm's signature)

\_\_\_\_\_ [Report Date]



◆ \_\_\_\_\_  
**20.916 Compilation Report on Specified Elements, Accounts, or Items of a Financial Statement**

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I (We) have compiled the accompanying Schedule of Net Sales of XYZ Company, Inc. for the year ended December 31, 19X.

My (Our) compilation was limited to presenting in the form of a Schedule of Net Sales information that is the representation of management (the owners). I (We) have not audited or reviewed the accompanying Schedule of Net Sales and, accordingly, do not express an opinion or any other form of assurance on it (them).

(Firm's signature)

\_\_\_\_\_ [Report Date]





**20.917 Compilation Report on Special-Purpose Financial Presentation Pursuant to An Acquisition Agreement That Results in a Presentation That Is Not in Conformity With GAAP or OCBOA**

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I (We) have compiled the special-purpose statement of assets and liabilities of ABC Company, Inc. as of December 31, 19X, and the related special-purpose statements of revenue and expenses and of cash flows for the year then ended in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

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

The accompanying special-purpose financial statements were prepared for the purpose of complying with the acquisition agreement between ABC Company, Inc. and XYZ Company, Inc. described in Note X, and are not intended to be a presentation in conformity with generally accepted accounting principles.

(Firm's signature)

\_\_\_\_\_ [Report Date]

**Note:** This report is intended for the information and use of the boards of directors and managements of ABC Company, Inc. and XYZ Company, Inc. and should not be used for any other purpose.





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**20.918 Standard Compilation Report — Prescribed Form**

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(We) have compiled the balance sheet of XYZ Company, Inc. as of December 31, 19X and the related statements of income, retained earnings, and cash flows for the year then ended included in the accompanying prescribed form in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

My (Our) compilation was limited to presenting in the form prescribed by the Jersey Department of Transportation information that is the representation of management (the owners). I (We) have not audited or reviewed the financial statements referred to above and, accordingly, do not express an opinion or any other form of assurance on them.

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

(Firm's signature)

\_\_\_\_\_ [Report Date]



**20.926 Standard Review Report**

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I (We) have reviewed the accompanying balance sheet of XYZ Company, Inc. as of December 31, 19X, and the related statements of income and retained earnings and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in those financial statements is the representation of the management (owners) of XYZ Company, Inc.

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

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

(Firm's signature)

\_\_\_\_\_ [Report Date]



**20.927 Review Report — GAAP Departure With Effect Determined**

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I (We) have reviewed the accompanying, balance sheet of XYZ Company, Inc. as of December 31, 19X, and the related statements of income and retained earnings and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in those financial statements is the representation of the management (owners) of XYZ Company, Inc.

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

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

As disclosed in Note X to the financial statements, generally accepted accounting principles require that inventory cost consist of material, labor and overhead. Management has informed me (us) that the inventory of finished goods and work in progress is stated in the accompanying financial statements at material and labor cost only. This departure from generally accepted accounting principles has understated inventories and retained earnings by \$xxx and \$xxx, respectively, at December 31, 19X, and overstated net earnings by \$xxx for the year then ended.

(Firm's signature)

\_\_\_\_\_ [Report Date]



**20.928 Review Report — GAAP Departure With Effect Not Determined**

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I (We) have reviewed the accompanying balance sheet of XYZ Company, Inc. as of December 31, 19X, and the related statements of income and retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management (owners) of XYZ Company, Inc.

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

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

As discussed in Note X to the financial statements, generally accepted accounting principles require that inventory cost consist of material, labor, and overhead. Management has informed me (us) that the inventory of finished goods and work in process is stated in the accompanying financial statements at material and labor cost only, and that the effects of this departure from generally accepted accounting principles on financial position, results of operations, and cash flows have not been determined.

(Firm's signature)

\_\_\_\_\_ [Report Date]



**20.929 Review Report — Statement of Cash Flows Omitted**

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I (We) have reviewed the accompanying balance sheet of XYZ Company, Inc. as of December 31, 19X, and the related statement of income and retained earnings for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management (owners) of XYZ Company, Inc.

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

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

A statement of cash flows for the year ended December 31, 19X has not been presented. Generally accepted accounting principles require that such a statement be presented when financial statements purport to present financial position and results of operations.

(Firm's signature)

\_\_\_\_\_ [Report Date]



**20.930 Review Report — Changed Reference to a Prior-Period Departure From GAAP**

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I (We) have reviewed the accompanying balance sheets of XYZ Company, Inc. as of December 31, 19X and 19W, and the related statements of income and retained earnings and cash flows for the years then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in those financial statements is the representation of the management (owners) of XYZ Company, Inc.

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

In my (our) previous review report dated April 5, 19X, on the 19W financial statements, I (we) referred to a departure from generally accepted accounting principles because the company carried its land at fair market value. However, as disclosed in Note X, the Company has restated its 19W financial statements to reflect its land at cost in accordance with generally accepted accounting principles.

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

(Firm's signature)

\_\_\_\_\_ [Report Date]



**20.931 Reviewed Current Period — Audited Prior Period**

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I (We) have reviewed the accompanying balance sheet of XYZ Company, Inc. as of December 31, 19X, and the related statements of income and retained earnings and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in those financial statements is the representation of the management (owners) of XYZ Company, Inc.

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

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the 19X financial statements in order for them to be in conformity with generally accepted accounting principles.

The financial statements for the year ended December 31, 19W, was (were) audited by me (us) and I (we) expressed an unqualified opinion on them in my (our) report dated April 5, 19X, but I (we) have not performed any auditing procedures since that date.

(Firm's signature)

\_\_\_\_\_ [Report Date]



**20.932 Reviewed Current Period — Compiled Prior Period**


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I (We) have reviewed the accompanying balance sheet of XYZ Company, Inc. as of December 31, 19X, and the related statements of income and retained earnings and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in those financial statements is the representation of the management (owners) of XYZ Company, Inc.

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

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the 19X financial statements in order for them to be in conformity with generally accepted accounting principles.

I (We) have compiled the accompanying 19W financial statements of XYZ Company, Inc. in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. A compilation is limited to presenting in the form of financial statements information that is the representation of management. I (We) have not audited or reviewed the 19W financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

(Firm's signature)

\_\_\_\_\_ [Report Date]





**20.933 Prior Period Reviewed by Other Accountants**

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I (We) have reviewed the accompanying balance sheet of XYZ Company, Inc. as of December 31, 19X, and the related statements of income and retained earnings and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in those financial statements is the representation of the management of XYZ Company, Inc.

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

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the 19X financial statements in order for them to be in conformity with generally accepted accounting principles.

The 19W financial statements of XYZ Company, Inc. were reviewed by other accountants whose report dated April 5, 19X, stated that they were not aware of any material modifications that should be made to those statements in order for them to be in conformity with generally accepted accounting principles.

(Firm's signature)

\_\_\_\_\_ [Report Date]





**20.934 Review Report — Balance Sheet Only**

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I (We) have reviewed the accompanying balance sheet of XYZ Company, Inc. as of December 31, 19X, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in this balance sheet is the representation of XYZ Company, Inc.

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

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

(Firm's signature)

\_\_\_\_\_ [Report Date]



**20.935 Review Report — Supplementary Information Subjected to Review Procedures**

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I (We) have reviewed the accompanying balance sheet of XYZ Company, Inc. as of December 31, 19X, and the related statements of income and retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management (owners) of XYZ Company, Inc.

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

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

My (Our) review was made for the purpose of expressing limited assurance that there are no material modifications that should be made to the financial statements in order for them to be in conformity with generally accepted accounting principles. The information included in Schedules \_\_\_\_ is presented only for supplementary analysis purposes. This information has been subjected to the inquiry and analytical procedures applied in the review of the financial statements and I am (we are) not aware of any material modifications that should be made to that information.

(Firm's signature)

\_\_\_\_\_ [Report Date]



**20.936 Review Report — Supplementary Information Not Subjected to Review Procedures**

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I (We) have reviewed the accompanying balance sheet of XYZ Company, Inc. as of December 31, 19X, and the related statements of income and retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management (owners) of XYZ Company, Inc.

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

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

My (Our) review was made for the purpose of expressing limited assurance that there are no material modifications that should be made to the financial statements in order for them to be in conformity with generally accepted accounting principles. The information included in Schedules \_\_\_ is presented only for supplementary analysis purposes. This information has not been subjected to the inquiry and analytical procedures applied in the review of the financial statements. I (We) compiled this information from information that is the representation of management (the owners), without audit or review and I (we) do not express an opinion or any other form of assurance on this supplementary information.

(Firm's signature)

\_\_\_\_\_ [Report Date]



**20.937 Review Report — Income Tax Basis Financial Statements**

\_\_\_\_\_  
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I (We) have reviewed the accompanying statement of assets and liabilities—income tax basis of XYZ Company, Inc. as of December 31, 19X, and the related statement(s) of revenue and expenses (and retained earnings)—income tax basis for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management (owners) of XYZ Company, Inc.

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

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

(Firm's signature)

\_\_\_\_\_ [Report Date]



**20.938 Review Report — Cash Basis Financial Statements**

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I (We) have reviewed the accompanying statement of assets and liabilities—cash basis of XYZ Company, Inc. as of December 31, 19X, and the related statement(s) of revenue and expenses (and retained earnings)—cash basis for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management (owners) of XYZ Company, Inc.

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

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

(Firm's signature)

\_\_\_\_\_ [Report Date]



**20.939 Review Report on Special-Purpose Financial Presentation Pursuant to An Acquisition Agreement That Results in a Presentation That Is Not in Conformity With GAAP or OCBOA**

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I (We) have review the special-purpose statement of and liabilities of ABC Company, Inc. as of December 31, 19X, and the related special-purpose statements of revenues and expenses and of cash flows for the year then ended in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these statement is the representation of management (the owners) of ABC Company, Inc.

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

The accompanying special-purpose financial statements were prepared for the purpose of complying with the acquisition agreement between ABC Company, Inc. and XYZ Company, Inc. described in Note X, and are not intended to be a presentation in conformity with generally accepted accounting principles.

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

(Firm's signature)

\_\_\_\_\_ [Report Date]

**Note:** This report is intended for the information and use of the boards of directors and management of ABC Company, Inc. and XYZ Company, Inc. and should not be used for any other purpose.









**CHAPTER 21**  
**CONSULTING SERVICES**

**Table of Contents**

<u>Section</u>		<u>Page</u>
21.000	INTRODUCTION	21-3
21.100	GENERAL APPROACH TO PROVIDING CONSULTING SERVICES	21-4
21.104	Identify Needs and Collect Information	21-5
21.108	Analyzing Client Needs	21-6
21.112	Outlining an Informal Plan	21-7
21.114	Proposing the Plan	21-8
21.119	Overcoming Barriers to Performing Business Planning	21-10
21.200	OBTAINING FUNDS FOR A SMALL BUSINESS	21-11
21.205	The Practitioner's Responsibilities and Compliance with Professional Standards	21-12
21.209	Gathering Information	21-13
21.213	Preparation of the Funding Proposal Package	21-13
21.215	Identifying Information for Inclusion	21-14
21.220	Typical Documents Included in a Loan Package	21-15
21.221	Preparing the Package for Submission	21-15
21.223	Example of Useful Documents and Schedules for Workpaper Files	21-15
21.224	Concluding the Engagement	21-16
21.300	ILLUSTRATIONS AND EXHIBIT	21-17
21.400	HELPING CLIENTS CHOOSE GENERAL LEDGER SOFTWARE	21-41

## CHAPTER 21

### CONSULTING SERVICES

#### Table of Contents (Continued)

<b><u>Section</u></b>		<b><u>Page</u></b>
21.403	Required Capabilities	21-42
21.404	Ease of Transition	21-42
21.405	Ease of Training	21-43
21.406	Manuals and On-screen Help	21-43
21.408	Technical Support	21-44
21.410	Access to User Groups	21-44
21.411	Security and Backup Features	21-44
21.414	Auditability	21-45
21.416	Cost	21-45

## CHAPTER 21

### CONSULTING SERVICES

#### 21.000 INTRODUCTION

**21.001** The AICPA publication "Advisory Comments for Growth and Profitability - A Guide for Accountants and Consultants" notes that:

Changes in our economy, business practices, and technology have dramatically increased competition for audit clients. These trends have altered the traditional relationship between client and auditor. Increasingly, the auditor is assuming an additional role of business advisor. This role provides a competitive advantage by enhancing the auditor's value to the client.

**21.002** This chapter provides information to help accountants assume their role as business advisors.

**21.003** The applicable professional standard for providing business consulting services is The Statement on Standards for Consulting Services No. 1, *Consulting Services: Definitions and Standards* (SSCS No. 1). As described in the Statement, consulting services may include:

- *Consultations*, in which the practitioner's function is to provide counsel in a short time frame. This service is based mostly on existing personal knowledge about the client, the circumstances, the technical matters involved, client representations, and the mutual intent of the parties. Examples include: reviewing and commenting on a client-prepared business plan and suggesting computer software for further client investigation.
- *Advisory services*, in which the practitioner's function is to develop findings, conclusions, and recommendations for client consideration and decision making. Examples of advisory services are an operational review and improvement study, analysis of an accounting system, assistance with strategic planning, and definition of requirements for an information system.
- *Implementation services*, in which the practitioner's function is to put an action plan into effect. Client personnel and resources may be pooled with the practitioner's to accomplish the implementation objectives. The practitioner is responsible to the client for the conduct and management of engagement activities. Examples of these services include: providing computer system installation and support, executing steps to improve productivity, and assisting with the merger of organizations.

- *Transaction services*, in which the practitioner's function is to provide services related to a specific client transaction, generally with a third party. Examples of transaction services are insolvency services, valuation services, preparation of information for obtaining financing, analysis of a potential merger or acquisition, and litigation services.
- *Staff and other support services*, in which the practitioner's function is to provide appropriate staff and possibly other support to perform tasks specified by the client. The staff provided will be directed by the client as circumstances require. Examples of staff and other support services are data processing facilities management, computer programming, bankruptcy trusteeship, and controllership activities.
- *Product services*, in which the practitioner's function is to provide the client with a product and associated professional services in support of the installation, use or maintenance of the product. Examples of product services are the sale and delivery of packaged training programs, the sale and implementation of computer software, and the sale and installation of systems development methodologies.

**21.004** This Chapter focuses on two of the more prevalent services provided:

- Obtaining funds for small businesses (transaction)
- Helping clients choose a general ledger software package (consulting)

**21.005** The AICPA publishes a number of practice aids, training courses, and other publications for practitioners who provide consulting services to their clients. To obtain a copy of the current AICPA catalog, call 1-800-862-4272. An on-line version is also available on the Accountant's Forum.

## **21.100 GENERAL APPROACH TO PROVIDING CONSULTING SERVICES**

**21.101** In some instances, the client will approach the practitioner with a clearly identified need for consulting services. For example, the entity becomes involved in a lawsuit and needs litigation support services.

**21.102** More often, the client will rely on the practitioner to identify and articulate the need for additional services. For example, the changing circumstances of the owners of a family-held business may require the development of a business succession plan. The family members themselves may not recognize the need, but a CPA experienced in these matters would.

**21.103** The following is a general approach for CPAs to identify, articulate, and provide consulting services to small business clients:

1. Identify needs and collect information for potential suggestions. Often, this may take place during an audit or review.
2. Consider the company's stage of development. Analyze the client's needs in light of their development stage and identify their highest level of need.

3. Outline an informal plan for the client that focuses on specific needs.
4. Propose a plan to help the client accomplish its objectives.
5. Assist management in finalizing and implementing the plan.

### **Identify Needs and Collect Information**

**21.104** Traditionally, audit teams have relied on the work of staff accountants to identify management letter comments. The CPA firm then relies on the management letter to provide the basis for providing additional consulting services. In practice, this approach has several problems:

- Management letters are often poorly written and hard to read
- Suggestions are often commonplace or internal-control oriented.
- Most letters are written and delivered well after the engagement is over. On many small engagements, letters are not issued at all.

**21.105** Management letters should not be eliminated. However, as a source for additional consulting services, CPA firms may want to supplement the management letter process with other procedures.

**21.106** The effective identification of client needs and possible consulting services will require the involvement of the engagement partner. Most needs are identified during audit planning, the final analytical review of the financial statements, or periodic, informal contact with the client's management. Most needs are **not** identified by the engagement partner during a detailed review of the audit workpapers.

**21.107** To identify needs, the practitioner should focus on the overall circumstances of the company, its principals, and the business environment in which it operates. For example, consider the following:

- What is the general direction of the company? Are they expanding (new territory or products)? Have they leveled off? Are they pulling back in certain areas?
- What sort of internal challenges face the company? Are personnel, equipment and facilities adequate to support management's plans for the business? Are financing levels and sources appropriate?
- What are the external factors that affect the company? How competitive is the industry? What is its general health and direction (expanding, mature, shrinking)? What is the impact of government regulations?
- What are the personal needs of the company's principals? Do they need cash or do they want to keep it in the business? Are their personal needs compatible and consistent with their plans for the company?

### Analyzing Client Needs

**21.108** Client needs will usually relate directly to its stage of development. Commonly recognized phases of development and highest levels of need are:

<u>Phase</u>	<u>Highest Level of Need</u>
Start-up	Survival--growth decisions
Entrepreneurial Expansion	Leader development
Professional Management	Management team development

**21.109** As companies grow there are other stages of development to consider. Auditors of small businesses are generally concerned with companies in the start-up and, perhaps occasionally, those moving into the entrepreneurial expansion phase.

**21.110** Practitioners should identify the company's phase of development. The characteristics that usually describe companies in start-up and entrepreneurial expansion phase are described in the table below.

Characteristics of Companies by Development Stage		
	Start-Up	Expansion
Management style	Owners run the company. Employees and owners work long hours for modest pay.	One person directs the operations. Relationships among employees and management become less personal.
Management emphasis	Owners emphasize producing products, services, and selling. They react more to customers' needs than to employees' needs.	All functional components, such as purchasing, inventory, budgeting, personnel, accounting, etc., receive attention.
Communication channels	Organization and communication is informal.	Organization and lines of communication is formalized.
Growth	Growth is normally moderate.	Faster growth rate. Multiple locations being considered.

**21.111** Client needs are usually related to the problems they face. The typical problems faced by companies in the start-up and entrepreneurial expansion phase are described below.

**Start-Up.** Problems typically encountered by companies in the start-up phase include:

- Often it is not clear who is in charge.
- Conflicts among co-owners are common.
- Old employees battle new employees.
- Newer employees are not motivated by dedication of owners.
- There never is enough working capital.
- Few internal controls and weak accounting systems are common.
- There is frequent temptation for owners to diversify to other businesses.

**Entrepreneurial Expansion.** Problems typically encountered by companies in the entrepreneurial expansion phase include:

- The direction is not well defined. The leader has difficulty organizing, planning, motivating and delegating.
- Supervisors of functional areas want to make decisions but are not allowed to do so.
- Problems are solved slowly, sometimes not at all.
- Key employee turnover is prevalent.
- Cash shortages occur often.
- Time management problems frequently arise.
- Diversification temptations still persist.

### **Outlining an Informal Plan**

**21.112** Developing a plan to provide consulting services is not done by the practitioner in a vacuum. The practitioner will not prepare a plan and then “sell” it to the client. Rather, a consulting services plan is a collaborative effort between the practitioner and the client. After the company’s problems and needs have been identified, the engagement partner’s role will be to meet with the client and guide their thought process.





**21.113** To prepare for the meeting, the engagement partner should prepare an outline of an informal plan. Such a plan will usually not be in paragraph or sentence format, but merely a list of client needs, prioritized in order of importance. For both start-up phase and entrepreneurial expansion phase companies, critical elements of the informal plan may include:

- Developing budgeting and forecasting capabilities.
- Reviewing financial performance, at least quarterly with engagement partner chairing meeting.
- Designing and implementing basic accounting systems.
- Developing good banking relationships.
- Performing product break-even analyses.
- Planning sales.
- Planning inventory and production.
- Developing management and leadership capabilities.
- Recruiting and developing personnel and compensation planning.

### **Proposing the Plan**

**21.114** When discussing possible business consulting services, the engagement partner should not try a “hard sell” designed to convince the client of a need. A more effective approach is to act as a facilitator, to help the client discover their own needs. This concept incorporates the most basic principle of salesmanship--most people trust their judgment first and cannot be sold a product or service unless they perceive a need.

**21.115** To enable clients to perceive need, the practitioner should stimulate a significant, emotional event to which the client can relate. Selling consulting services is most effective when the client participates emotionally in the process. Practitioners may use flipcharts, overhead projector transparencies, charts and graphs and other means to visually portray events that are meaningful to the client. Examples about experiences of other companies will also help the client participate in the development of the consulting services plan.

**21.116** The following is a basic approach to facilitating a management meeting. (See Illustration No. 21-1 for a sample agenda for a planning meeting.)

1. The engagement partner schedules the meeting for a least a half-day, at a location away from the partner's and the client's office.
2. The partner supplies the client with advance questions that relate, first, to the personal objectives of the owner and, second, to the objectives of the business. The meeting discussion will usually begin with the owner supplying answers to these questions.

3. Once the partner understands the owner's personal and business objectives, the educational process can begin. Drawn from the partner's preliminary outline of the client's business plan, the partner will supply information (create experiences) for the client concerning, at a minimum, these key elements for success as they relate to the client's needs:
  - a. Good customer service.
  - b. Effective marketing and selling.
  - c. Expanding product capabilities or base.
  - d. Educating consumers.
  - e. Training, developing, and retaining employees.
  - f. Planning financial strategies.

**21.117** Once the client has sufficient knowledge of his or her areas of need, the engagement partner can begin the problem definition and solution process. During the next phase, it is important for the partner to continue to facilitate the client's self-discovery of needs.

**21.118** The management meeting should generate basic information for the partner and client to formalize the business plan and implement change. A summary of items to consider in preparing a business plan follows: (See Illustration No. 21-2 for a detailed sample outline of a business plan).

1. Define the nature of the business, current and future.
2. Identify the specific nature of the key elements for the client's success.
3. Establish financial goals:
  - a. Growth rate.
  - b. Gross revenues.
  - c. Profit percentages.
  - d. Capital additions.
  - e. Planned analytical ratios.
  - f. Expected return on investment.
4. Define problems and planned approaches to solutions.
5. Establish marketing goals:
  - a. New product development.
  - b. Planned phase-out of old products.
  - c. New targeted geographic areas.
  - d. Objectives of advertising program.
  - e. Market size and planned share.

6. Sales projections:
  - a. By product.
  - b. By salesperson.
  - c. By geographic area.
  - d. By customer type.
  - e. For planned new customer acquisitions.
7. Competition:
  - a. Identification.
  - b. Competition's advantages.
  - c. Client company's advantages.
8. Organization charts, current and after planned changes.
9. Personnel requirements:
  - a. Needs by department, function, and skills.
  - b. Recruiting plans.
  - c. Training plans.
10. Cash flow forecasts.
11. Forecasted financial statements:
  - a. Balance sheets.
  - b. Earnings statements.
  - c. Statements of cash flows.
12. Detailed assumptions supporting the financial and operations plans.
13. Plans for special projects or major changes included in the plan.
14. Progress summary form.

### **Overcoming Barriers to Performing Business Planning**

**21.119** Few CPA firms are better qualified to serve the needs of small business than the small- to medium-size CPA firm. Yet few small- to medium-size CPA firms perform, or are consciously planning to perform, such services. Practitioners offer a number of common excuses for not providing consulting services, but these excuses are more perceived than real.

- *Excuse: I've never actually run a business, so how can I advise a client?*

Response: Running a CPA firm is one of the most difficult business-management tasks one can experience. Working with a myriad of small clients on a personal basis provides the small-firm CPA with more business management experience than most career business managers.

- *Excuse: I'm not a good salesperson, and business planning requires a hard sell.*

Response: Hard selling is rarely effective for any product or service, let alone business planning. To be effective, the service must meet genuine, not manufactured, needs of the client. If the proposed services satisfy a real client need, they won't need to be sold; the client will make the purchase on their own.

- *Excuse: There's not enough time to perform our compliance services, let alone do something new.*

Response: The CPA firm marketplace is changing. Firms are making long-range growth decisions by deciding to remain compliance-oriented or to expand to the new service areas. Most believe the new service areas will be the source of our practice survival in the future. Firms can make time to develop new expertise if they have the desire.

- *Excuse: My clients don't need business planning because they know what they're doing.*

Response: Very few small-client engagements are producing the returns of which they are capable. More than any other phase of development, the start-up or entrepreneurial-expansion phase clients need CPAs' assistance.

- *Excuse: My clients come to me for answers, not to have me ask them for answers.*

Response: CPAs have been professionally groomed as experts from whom others seek advice. Facilitating a management meeting requires a tolerance for ambiguity and the ability to shed the role of the expert. Some practitioners, for whatever reasons, simply don't want to shed their experts role, or they feel unqualified as facilitators. For many it will require strengthening their human relations skills. It is true, clients look to CPAs to help find answers. It is also true they are more apt to act on those answers if they have played a key role in their discovery.

## **21.200 OBTAINING FUNDS FOR A SMALL BUSINESS**

**21.201** Practitioners are often asked to help clients obtain funds to meet short-term needs or to finance business expansion. This section discusses identifying sources of funds for small businesses and preparing the documents and schedules requested by potential lenders or investors.

**21.202** Establishing the scope of the engagement is an important first step because the scope of this type of engagement can vary. It may include helping the client select potential sources of funds or preparing required information, or both. It may include additional work, such as the audit, review, or compilation of the historical financial statements. The practitioner might also accompany the client to interviews with potential funding sources to answer questions about the financial data.



**21.203** The practitioner should confirm the terms of the engagement in writing. An engagement letter normally includes the scope of the work to be performed, the work product to be delivered, and a clear delineation between the client's responsibilities and the responsibilities of the practitioner. The client should clearly understand that the practitioner does not guarantee that his or her assistance will result in obtaining funds.

**21.204** The engagement letter normally includes a discussion of fee arrangements. Rule 302 of the AICPA Rules of Conduct prohibits a practitioner from accepting a contingent fee in most situations when they are involved with helping a client obtain funds.

### **The Practitioner's Responsibilities and Compliance with Professional Standards**

**21.205** A practitioner who performs an audit, review, or compilation of a client's current financial data, or is associated with prospective financial information, is required to comply with appropriate standards and guidance for those services promulgated by the AICPA. Nothing in this section is intended to change or is in conflict with such requirements. The matters discussed in this section refer to the other services a practitioner provides when such financial data is to be used for the purpose of applying for funding from lenders or investors.

**21.206** A loan package typically includes other, nonfinancial information, for example a description of the company's business and its management team. A practitioner who performs an audit of financial statement that are included in a loan proposal should consider the guidance contained in SAS No. 8, *Other Information in Documents Containing Audited Financial Statements*, (AU §550). Among other, the section states:

- The auditor's responsibility with respect to other information does not extend beyond the financial information identified in the audit report.
- The auditor has no obligation to perform any procedures to corroborate other information.
- However, the auditor should read the other information and consider whether it is materially inconsistent with information appearing in the financial statements.

**21.207** Practitioners who perform services other than an audit of historical financial statements, are not required to comply with this audit standard. However, as a practical matter, most practitioners follow the guidance of SAS No. 8, regardless of the level of service performed on the financial information.

**21.208** The prudent practitioner also prepares an appropriate letter of transmittal to accompany the loan package. The purpose of this letter is to clearly describe the nature of the practitioner's work (i.e., review of historical financial statements, compilation of prospective financial statements, and assistance in preparation of nonfinancial information) and the degree of responsibility he or she is taking. Practitioners may also:

- Describe the purpose of the information not covered by his or her report.
- Limit distribution of the loan package.

## Gathering Information

**21.209** The practitioner needs to determine the following:

- a. What amount of funds will be needed?
- b. For how long will the funds be needed?
- c. How soon will they be needed?
- d. Can the client offer collateral?
- e. What is the intended use of the proceeds?
- f. Would funding through equity or debt methods be preferable?
- g. What repayment program might be desirable and feasible if the debt method is chosen?

**21.210** These questions and their answers will help the practitioner make initial judgments regarding likely sources and the documents and schedules needed for the financing package. (See Illustration No. 21-3 for guidance regarding uses and sources of funds for small businesses.)

**21.211** When assisting a small business client in obtaining funds, the practitioner gathers information in sufficient detail to--

- Identify potential client weaknesses that may require reconsideration of the practitioner's initial judgments concerning the probable funding approach.
- Identify strengths the client may emphasize in making presentations to potential sources of funds.
- Corroborate preliminary survey data and confirm the understanding of the engagement.

**21.212** The client's reasons for seeking funds will often determine which type of lender or investor is most appropriate. (See Exhibit No. 21-A for a discussion of external service of funds, the types of loans or investments they make and their requirements.)

## Preparation of the Funding Proposal Package

**21.213** The practitioner may help the client prepare information for presentation to potential lenders or investors. This may involve developing a funding plan proposal that identifies the preferred method of financing (equity or debt, and what type) and a preferred source. For debt financing, the plan also identifies the preferred repayment schedule and approximate maximum loan cost.

**21.214** When a client has approved a proposed funding plan, the practitioner helps prepare the formal package for submission to the selected funding source. In this phase of the engagement, the practitioner uses all the information gathered and all decisions made to prepare a package that accurately and effectively presents the client's case. This section discusses some of the tasks the practitioner may perform while assisting the client in the preparation of the funding proposal package.



### Identifying Information for Inclusion

**21.215** The evaluation of credit risks can never be reduced to an exact formula, nor can the lender predetermine precisely the maximum amount the applicant can repay. The funding proposal package provides the potential lender or investor with information that is helpful in making a decision. The following material is usually of primary interest to a prospective lender or investor.

- If available, data concerning budgets and cash projections of past periods can be helpful. Comparisons of actual results with budgets, especially if variations were insignificant or favorable, may strengthen confidence in current budgets and projections.
- A schedule of the provisions for repayment, unless they are clearly indicated in the cash flow projections or other schedules.
- Past earnings history and other historical financial data with explanations of any losses and unusual revenues in past years.
- Facts about the management and officers (ages, background, experience, attitudes, and so on).

**21.216** Financial information may be more helpful to a lender or investor if it includes more than basic financial statements. For example, a lender will often want the following information:

- The aging of receivables, with details regarding any concentration in a few customers, and the details of notes receivable and the risks of collection.
- Inventories with details on classification, price stability, aging, and turnover.
- Investments, fixed assets, other assets, and detailed or supplementary schedules, giving market or appraisal value when appropriate.
- Liabilities and reserves, with explanations.

**21.217** In addition, bankers may request detailed information about the collateral to be offered and may require personal financial information in connection with loan guarantee agreements.

**21.218** In general, the client should provide the lender with as much useful information as possible. Information about unfavorable items should be accompanied by details of management's plans to resolve the problem. Full disclosure will almost always help the client's case. It could be disastrous if the bank or potential investor discovers a negative factor on their own.

**21.219** The practitioner can provide valuable guidance concerning data that should be included in the funding proposal package.

**21.220 Typical Documents Included in a Loan Package**

- Description of the business
- Company history
- The management team
- Business plan and use of proceeds
- Historical financial statements for 2 to 3 years to date of submission
- Financial statement supplemental schedules at current date
  1. Aged receivables
  2. Inventories
  3. Fixed assets
  4. Aged accounts payable
  5. Notes and loans payable
  6. Other material accounts
- Financial projections for 1 to 2 years, indicating how funds will be used and/or repaid.
- Personal financial statements of owners, etc.

**Preparing the Package for Submission**

**21.221** Because many small businesses may not have the staff or the ability to put together a package for submission, the practitioner will often do a substantial part of the work.

**21.222** Whether an equity or debt method is selected, a key part of the funding proposal package will be the current and historical financial statements and prospective financial information. The specific information and degree of detail to be incorporated in the funding proposal package depends on the client's circumstances and on investors' or lenders' requirements. When in doubt, the practitioner inquires of the potential source to limit unnecessary work and client expense.

**21.223 Example of Useful Documents and Schedules for Workpaper Files.** When performing an engagement to help a client obtain funds, the following may be included in a workpaper file.

1. Engagement letter which describes the scope of the services to be performed and clearly delineates the responsibilities taken by the client and those accepted by the practitioner.
2. Client's representation letter
3. Copies of prior financial statements
4. Work program for funding package and supporting documents



5. Memo that the practitioner has read the other information and considered whether it, or the manner in which it is presented, is materially inconsistent with information presented in the financial statements.
6. Memo about conferences with principals outlining the assumptions, objectives, and needs
7. Historical schedule of sales by product line for each month to develop cyclical data (inventories, cash, loans, and so forth)
8. Supporting schedule for assumptions regarding projected sales, indicating elements that create changes, such as sales mix, unit price change per estimated inflation rate, new products, expansion sales territory, and enhanced product reputation
9. Gross margin analysis by product line
10. Expense projections, indicating amounts and basis for assumptions, such as increased staff, increased facilities, and inflation
11. Schedule of net cash receipts on sales, indicating timing, amount, and estimated attrition of receivables, discounts, bad debts, and returns
12. Schedule of calculation of inventory levels
13. Loan, lease, and stock restrictions
14. Schedule and documentation to support capital need

### **Concluding the Engagement**

**21.224** The submission of the funding proposal package concludes this phase of the engagement. The practitioner may be requested to accompany the client to discuss the package with the potential lender or investor. If the client receives the funds, the practitioner may still be involved in providing reports and financial statements to the lender or investor.

**21.225** If the client does not receive the funds, the practitioner may:

- Suggest revisions to a rejected funding proposal that might make it acceptable (revising the amount requested, modifying the business plan and so forth).
- Help the client identify another source of funding.
- Review and comment on loan documents to determine whether conditions listed are achievable and whether they are the ones to which the parties previously agreed.

**21.226** Many long-term relationships between practitioners and clients have resulted because of the help in obtaining funds for small businesses.

**21.300 ILLUSTRATIONS AND EXHIBIT**

<b><u>Section</u></b>	<b><u>Description</u></b>	<b><u>Page</u></b>
21.301	Illustration 21-1—Sample Agenda for a Planning Meeting	21-18
21.302	Illustration 21-2—Sample Outline of a Business Plan	21-24
21.303	Illustration 21-3—Uses and Sources of Funds for Small Businesses	21-28
21.304	Exhibit 21-A—External Sources of Funds	21-34
21.307	The Commercial Bank	21-34
21.308	Types of Bank Loans	21-34
21.315	Bank Lending Policies	21-35
21.319	Bank Lending Conditions	21-36
21.325	Limitations on Commercial Bank Financing	21-37
21.326	Interest Rates	21-37
21.327	The Commercial Finance Company	21-37
21.328	Accounts Receivable Financing	21-37
21.335	Factoring	21-38
21.339	Inventory Loans	21-39
21.342	Summary	21-39
21.343	Equipment Financing	21-39
21.344	Financing of Currently Owned Equipment	21-39
21.345	Financing of the Purchase of New Equipment	21-40
21.346	Sale-Leaseback	21-40
21.347	Lease Financing	21-40
21.349	Other Sources of Funds	21-40
21.349	Life Insurance Companies	21-40
21.352	Other Institutional Sources	21-40
21.353	The Small Business Administration	21-41
21.354	Venture Capital Organizations	21-41
21.355	Public Ownership	21-41

**Illustration No. 21-1****21.301 Sample Agenda for a Planning Meeting****Agenda and Introduction**

1. Purpose of planning retreat
  - a. Agenda
  - b. Program work plan
  - c. Administrative items

**Planning Process**

2. Overview of long-range planning
  - a. Purposes of formal long-range planning
  - b. Benefits of planning
  - c. Limitations of planning
  - d. Categories of general information useful in planning
  - e. Analysis of risks and opportunities
  - f. Structures of long-range planning

**Review of Current Year's Performance**

3. Results of planning retreat preparations
  - a. Summary of issues, ideas, and problems that surfaced during the management interview process.
  - b. Conclusions of operational evaluation
  - c. Phases of growth
4. Present year's successes
5. Present year's failures

**Illustration No. 21-1 (Continued)**  
**Sample Agenda for a Planning Meeting**

6. Current strengths and weaknesses
  
7. Current capabilities as affected by
  - a. Personnel
  - b. Customers
  - c. Products or services
  - d. Economy
  - e. Facilities
  - f. Equipment
  - g. Competition
  
8. Forces affecting performance
  - a. Production
  - b. Sales
  - c. Profits
  - d. Responsiveness
  - e. Employee effort
  
9. Reasons for profit performance, return on investment, and return on assets.

**Review of Company's History and Statistics**

10. Trends and statistics of previous four years
  - a. Balance sheet
  - b. Statement of earnings
  - c. Wages
  - d. Business ratios (e.g., financial, operational, efficiency, profitability)



**Illustration No. 21-1 (Continued)**  
**Sample Agenda for a Planning Meeting**

11. Customer rankings

**Future Expectations**

12. External changes having a major effect on the company, including changes in
- a. Economy
  - b. Employees
  - c. Shareholders
  - d. Customers
13. Industry changes having a major effect on the company
- a. Competition
  - b. Products
  - c. Markets
  - d. Technological development and changes
  - e. Changing nature of operations
14. 5- and 10-year goals in
- a. Sales volume
  - b. Number of locations
  - c. Management skills and responsibilities
  - d. Overall company structure and operations

**Growth Strategy**

15. Growth accomplishments for current year

**Illustration No. 21-1 (Continued)**  
**Sample Agenda for a Planning Meeting**

16. Current and future growth strategies
  - a. Products
  - b. Customers
  - c. Employees
  - d. Equipment
  - e. Competition
  - f. Location

**Company Values and Mission**

17. Product or service differentiation
  - a. Market segmentation and targeting
  - b. Quality and competitive edge
18. Financial ratios (as related to company's growth strategy)
19. Responsibility to interest groups
  - a. Employees
  - b. Customers
  - c. Suppliers
  - d. Owners
20. Management philosophy
21. Additional management concerns, uncertainties, or unresolved issues.
22. Relative priorities among competing goals



**Illustration No. 21-1 (Continued)**  
**Sample Agenda for a Planning Meeting**

23. Evaluation of present organization structure
  - a. Strengths
  - b. Weaknesses
  
24. Individual responsibilities in future organization structure
  
25. Annual employee performance reviews

**Customers, Marketing, and Sales**

26. Customer service and retention
  - a. Standards for acceptable customer service
  - b. Recent customer service performance
  - c. Criteria for seeking customers
  - d. Criteria for retaining customers
  
27. Performance of present marketing and sales programs
  - a. Necessary changes
  - b. Additional programs
  
28. Future marketing strategy

**Personnel Growth and Motivation**

29. Hiring, training and continuing education

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**Illustration No. 21-1 (Continued)**  
**Sample Agenda for a Planning Meeting**

**Long-Range Planning**

- 30. Statement of goals
  
- 31. Plans
  - a. Sales
  - b. Marketing
  - c. Production
  - d. Human resources
  - e. Organization
  - f. Finance
  - g. Control
  
- 32. Budgets



**Illustration No. 21-2****21.302 Sample Outline of a Business Plan**

- I. Cover Sheet** (name of company, address, principals)
- II. Table of Contents**
- III. Executive Summary** (2-3 pages)
- IV. The Business**
  - A. Description, history (including past performance)
    - 1. Form of business ( if incorporated, show where)
    - 2. Location of headquarters
    - 3. Principals or owners
  - B. Objectives of owners or managers
    - 1. Projections and forecasts
    - 2. Current and proposed capital structure
  - C. Funding required
    - 1. Equity
    - 2. Debt
  - D. Timing and use of funds
    - 1. When capital needed
    - 2. How funds will be used
- V. The Product or Service**
  - A. Description of brand names, prices
  - B. Comparison with competitive products or service (e.g., competitive advantages, weaknesses)

**Illustration No. 21-2 (Continued)**  
**Sample Outline of a Business Plan**

- C. Research and development
- D. Patents, trademarks, copyrights, franchises, and licensing agreements
- VI. Marketing Plan**
  - A. Overall strategy and tactics including risks and pitfalls
  - B. Size and history of market including trends (growth vs. flat)
  - C. Profiles of customers and end-users; preferences and needs
  - D. Strengths and weaknesses of competitors
  - E. Product lines
  - F. Advertising and promotions
  - G. Pricing
  - H. Distribution channels: distributors, dealers, sales representatives, associations, cooperatives.
  - I. Regulatory requirements

**Illustration No. 21-2 (Continued)**  
**Sample Outline of a Business Plan**

**VII. Production and Operations**

- A. Description of operations (all facets from raw materials to finished product)
  - 1. Workforce (management, rank, and file)
  - 2. Principal suppliers
  
- B. Facilities and equipment
  - 1. Existing
  - 2. Required
  
- C. Material, labor, and supplies used

**VIII. Financial Information**

- A. For existing companies, provide a summary of historical financial data
  
- B. Projected financial statements for three to five years
  - 1. Cash flow statements
  - 2. Income statements
  - 3. Balance sheets
  
- C. Significant financial assumptions (interest rates, profit margins, etc.).
  
- D. Accounting policies (depreciation, inventory valuation, receivables, collections, etc.)
  
- E. Break-even analysis

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**Illustration No. 21-2 (Continued)**  
**Sample Outline of a Business Plan**

**IX. Supporting Documents**

- A. Management biographies or resumes
- B. Organizational chart
- C. Historical financial statements for past three to five years
- D. Employment contracts or agreements and loan covenants
- E. Articles of incorporation
- F. By-laws

## Illustration No. 21-3

## 21.303 Uses and Sources of Funds for Small Businesses

Use of Funds	Type of Money	Source	Financing Vehicle
Business Start-Up	Equity	Nonprofessional investor	Partnership formation Stock issue
		Venture capitalist SBIC-MESBIC	Stock issue Convertible debentures Debt with warrants
	Long-term debt	Bank	Term loan (limited) Unsecured term loan Equipment loan Equipment leasing Real estate loan
		SBIC-MESBIC	Term loan (limited) Unsecured term loan Equipment loan Equipment leasing
		Commercial finance company	Equipment loan Equipment leasing Real estate loan
		Life insurance company	Policy loan Real estate loan
		Savings and loan association	Real estate loan
		Leasing company	Equipment leasing
		Consumer finance company	Personal property term loan

		Small Business Administration Economic Development Administration	Term loan guarantee loan Direct term loan (limited)
		Local development company	Facilities/equipment financing
Business Start-Up		Farmers Home Administration	Term loan guarantee
Working Capital	Long-term debt	Bank	Unsecured term loan Equipment loan Real estate loan
		Commercial finance company	Equipment loan Real estate loan
		Life insurance company	Policy loan Real estate loan Unsecured term loan (limited)
		Savings and loan association	Real estate loan
		Consumer finance company	Personal property loan
		Small Business Administration Economic Development Administration SBIC-MESBIC	Term loan guarantee Direct term loan (limited)

		Farmers Home Administration	Term loan guarantee
Seasonal Peak	Short-term debt and Line of credit	Supplier Bank	Trade credit Commercial loan Accounts receivable financing Flooring Indirect collection financing Unsecured line of credit
Seasonal Peak		Commercial finance company	Accounts receivable financing Inventory financing Factoring
		Factor	Factoring
		Life insurance company	Policy loan
		Consumer finance company	Personal property loan
		Small Business Administration	Line of credit guarantee (limited)
Equipment or Facilities Acquisition	Long-term debt	SBIC-MESBIC Bank Commercial finance company	Term loan Equipment loan Equipment leasing Real estate loan

		Life insurance company	Policy loan Unsecured loan (limited) Real estate loan
		Savings and loan association	Real estate loan
		Consumer finance company	Personal property term loan
		Leasing company	Equipment leasing
		Small Business Administration Economic Development Administration	Term loan guarantee Direct term loan (limited)
		Local development company	Facilities/equipment financing
Equipment or Facilities Acquisition		Farmers Home Administration	Term loan guarantee
Sharp, Sustained Growth	Equity	Nonprofessional investor	Partnership formation Stock issue
		Venture capitalist SBIC-MESBIC	Stock issue Convertible debentures Debt with warrants
	Long-term debt	SBIC-MESBIC	Term loan
		Bank	Unsecured term loan Equipment loan Equipment leasing Real estate loan



		Commercial finance company	Equipment leasing Real estate loan
		Life insurance company	Unsecured term loan Policy loan Real estate loan
		Savings and loan association	Real estate loan
		Consumer finance company	Personal property loan
		Leasing company	Equipment leasing
		Small Business Administration Economic Development Administration	Term loan guarantee Direct term loan (limited)
		Local development company	Facilities/equipment financing
		Farmers Home Administration	Term loan guarantee
Sharp, Sustained Growth	Line of credit	Supplier	Trade credit
		Bank	Unsecured line of credit Accounts receivable financing Inventory financing Flooring Indirect collection financing

		Commercial finance company	Accounts receivable financing Inventory financing Factoring
		Factor	Factoring
		Small Business Administration	Line of credit guarantee (limited)

**Exhibit No. 21-A****21.304 EXTERNAL SOURCES OF FUNDS**

**21.305** The CPA who wishes to provide the small business with meaningful assistance in its request for funds needs to have a working knowledge of the various institutions and organizations that exist to fill that need. Included in this section are discussions of commercial banks, commercial finance companies, equipment financing, and other sources of funds.

**21.306** However, one should not infer that financing roles are as clearly segregated as this section may suggest. Just as commercial banks compete with each other for business, they compete with finance companies for some types of business. Similarly, considerable overlap can exist when joint financing is arranged through two or more financial institutions, perhaps with the government also.

**The Commercial Bank**

**21.307** The commercial bank is the business person's most frequently used source of temporary funds. For a small business to qualify for bank financing, the owners must have sufficient equity and strong personal credit, since a bank's chief consideration in its lending policy is the safety of the funds entrusted to it by its depositors. The second consideration is the return that it will earn on the money it lends to borrowers.

**21.308 Types of Bank Loans.** The concept of the full-service bank—one ready to perform a wide range of banking and lending services—has greatly expanded the types of loans that are available. These include factoring, accounts receivable, and inventory financing (discussed under “Commercial Finance Companies”), and equipment loans (discussed under “Equipment Financing”). The more conventional types of commercial bank loans are described briefly in the following paragraphs.

**21.309 *Lines of credit.*** When a bank extends a line of credit, it is prepared to lend up to a certain amount of money as long as certain terms and conditions are met. The bank may cancel the line of credit at any time, but banks rarely do so without cause. The borrower may draw funds as needed. As a result, interest is charged only on the funds actually owed to the bank, although occasionally the borrower is required to pay a commitment fee on the entire line of credit to ensure the bank will make the loan when requested.

**21.310 *Straight commercial loans.*** Installment loans may be made for any productive business purpose. Payments are usually made monthly, and, as the obligation is reduced, it is possible to obtain refinancing at more advantageous rates. These loans may be tailored to a business's seasonal financing requirements.

**21.311 *Character loans.*** Character loans are short-term, unsecured loans made to individuals or companies of high credit standing who need the funds for general purposes.

**21.312 *Collateral loans.*** Collateral loans are made to individuals or companies who give security in the form of chattel mortgages, stocks and bonds, real estate mortgages, or life insurance.

**21.313 Bank credit cards.** Although not thought of as such, the bank credit card is a form of credit. The bank assumes the financing of the retailer's accounts receivable. For the retailer, a major advantage of the card is the ease with which purchases can be made. A second important advantage is the elimination of concern about enforcing credit policies for such purchases and the consequent reduction in the dollar investment in accounts receivable. Of course, these benefits must be weighed against the costs involved (the discount charged to the retailer by the bank).

**21.314 Term loans.** A term loan is a business loan with a maturity of not less than one year and, usually, no more than ten years. Term loans are used in situations in which short-term loans and financing do not adequately meet the borrower's needs. Term loans may be used to purchase new equipment, to purchase an existing business, to establish a new business, to provide additional working capital, to retire a bond issue or outstanding preferred stock, or for other reasons.

**21.315 Bank Lending Policies.** Bank loan officers study the borrower and its financial statements before granting loans. Bankers often require audited or reviewed statements from their borrowers as assurance of the reasonableness of the information contained in the statements. In studying the financial statements, bankers look at the key profitability and credit ratios, inventory turnover, and receivable liquidity. In addition, they are concerned with the amount of the owner's capital committed to the business and the rate of withdrawal of capital in the form of dividends and salary.

**21.316** The banker also studies the Cs of credit--character, capital, capacity, collateral, circumstances, and coverage. As for character, the banker wants to be certain that the borrower will do everything possible to conserve business assets and provide assurance that the indebtedness will be repaid. The borrower must also have sufficient amount of capital invested in the business and should not expect others to carry the financial burden for an extended period.

**21.317** Concerning capacity, the borrower should have some managerial skill to use the funds wisely and profitably. In addition, the borrower should have either a credit standing high enough to be able to borrow on an unsecured basis or tangible assets that can be pledged to reinforce a weaker credit position. The banker considers factors such as the seasonal character of the business, long-run business changes, the level of community business activity, the competitive position of the firm, and the nature of the product. Finally the small business should be covered against losses from causes such as the death of an owner, partner, or principal stockholder; stoppage of operations due to fire, flood, or explosion; theft and embezzlement; and liability suits.

**21.318** The banker looks for trouble signs in studying the borrower and the financial statements. Here are several warnings signs that might indicate problems:

- There are heavy inventories relative to sales.
- High dividends are paid, or salary withdrawals are excessive.
- There are substantial loans to officers.
- A high percentage of receivables is past due.
- Debt is high relative to capital plus retained earnings.

- Investments in property, plant, and equipment are too high.
- The company has an overextended credit position.
- The company's structure is unstable.

**21.319 Bank Lending Conditions.** Banks usually want the principals of the private or small company to endorse the note personally, and the borrower may be required to maintain a compensating balance with the bank. If the company's position is so weak it cannot provide assurance the loan will be repaid, the bank may require the company to ask someone to guarantee the loan. The rate of interest may vary with the size and term of the loan and the risk involved.

**21.320** Since term loans are of longer duration, bank lending policies concerning them are more formal. Generally, a loan agreement is negotiated between lender and borrower, stipulating the terms under which the loan is made. Along with the usual requirements of a loan agreement, it may impose specific limitations on the borrower. It may require that the borrower do one or more of the following:

- Maintain working capital at a specified minimum amount.
- Furnish audited (or reviewed) financial statements at periodic intervals.
- Provide assurance that there is no default of loan provisions.
- During the term of the loan, refrain from certain acts, such as
  - Paying dividends or redeeming capital stock.
  - Entering into a merger or consolidation or selling substantially all of the company's assets.
  - Creating or assuming any obligation for money borrowed by the company, except as provided by agreement.
  - Guaranteeing, endorsing, or becoming surety for or on the obligation of others.
  - Making capital expenditures in excess of a specified amount.
  - Selling receivables with or without recourse.
  - Making loans or advances to others in excess of a specified amount at any one time.
  - Purchasing securities other than those of the U.S. government.

**21.321** Term-money lenders usually ask borrowers to pledge collateral security, such as equipment or other property, in order to back up the loan. However, it is the ability of the borrower to repay the loan that is of prime importance. The lender looks at some key ratios, such as the current ratio and the net-worth-to-debt ratio, and is keenly interested in cash forecasts to measure the ability of the company to free cash.

**21.322** The term-loan agreement is based on the ability of the borrower to repay the loan out of earnings, generally in installments, by maturity of the loan. The borrower's compliance with the terms of the loan provides assurance that no payments other than regular installments will be required before the due date of the loan. The borrower has no registration expense--just the costs of securing the loan.

**21.323** A loan agreement can be revised or modified more readily than a bond indenture or a preferred stock arrangement.

**21.324** In a term loan, the lender and borrower have a relationship over a relatively long period, and the lender can advise small companies on financial matters.

**21.325 Limitations on Commercial Bank Financing.** With the rapid expansion of commercial banks into fields other than short-term, unsecured loans, one might wonder why the bank should not be the source of all required funds. Although banks are expanding into many fields, funds loaned out by banks are provided by depositors, and, consequently, are subject to very careful management and regulation. Therefore, a bank reviewing a loan application must consider the degree of risk involved and the ability of the borrower to repay. These considerations generally exclude loans to newly started businesses, high risk or venture businesses, and poorly managed businesses (as evidenced by their performance records).

**21.326 Interest Rates.** The prime interest rate, which is the rate charged by large banks to their most creditworthy corporate borrowers, is the base from which interest rates vary. A small business will pay more--perhaps one to two points more. Rates, of course, fluctuate, depending on many circumstances (the supply of money, the state of the economy, government policy, and so on); as these rates vary, the interest rates paid by the borrower also fluctuate.

### **The Commercial Finance Company**

**21.327** Commercial finance companies (sometimes referred to as asset-based or secured lenders) usually are asked to provide financial assistance when commercial banks are reluctant to extend credit.

**21.328 Accounts Receivable Financing.** Accounts receivable financing is an important service offered by commercial finance companies. Under this method of financing, the borrower assigns its accounts receivable to the lender to serve as security for the cash advances. When the borrower collects the accounts receivable, the proceeds are given to the lender, who reduces the borrower's indebtedness; any excess is returned to the borrower.

**21.329** The borrower is responsible for the collection of its accounts receivable. The accounts may be financed either on a notification basis or on a nonnotification basis. When the notification basis is used, the customer is informed of the assignment and is asked to remit directly to the finance company. Under the nonnotification method, payment is made directly to the borrower by the customer. When forwarding remittances to the lender, the borrower will usually prepare an accompanying remittance list. The nonnotification method is more prevalent because it minimizes the risk of jeopardizing the relationship between the borrower and its customers.

**21.330** A businessperson may enter into an agreement with a commercial finance company or another financial institution to accomplish several objectives. Needed working capital can be borrowed without diluting ownership or control of the business. The capital can be borrowed without entering into a long-



term financing arrangement, which may be unnecessary. The borrower is immediately able to obtain working capital by releasing funds partially frozen in accounts receivable, and working capital turnover is accelerated by the immediate conversion of accounts receivable to cash. The borrower is able to secure a continuous source of operating cash on a flexible basis because advances are made only when cash is needed. Having the capital to pay its bills more quickly, the borrower may improve its credit standing, save cash by taking advantage of cash discounts, or take advantage of opportunities for profit.

**21.331** Before an agreement is negotiated, the lender thoroughly investigates the borrower to determine whether to assume the risk of financing the accounts receivable. The investigation includes examination of the accounts receivable to assess their acceptability for financing.

**21.332** A contract is then drawn up between the borrower and the lender, since the two parties anticipate a continuing relationship rather than a single borrowing. The terms of the contract detail certain rules and procedures. The lender is to advance a certain percentage of the accounts that are assigned; the most common amount advanced is 80 percent of the assigned accounts that are not past due, as defined in the agreement. The borrower is to prepare a schedule of all assigned accounts.

**21.333** Any accounts overpaid to the lender will be (a) applied on account and adjusted in the next advance, (b) transmitted immediately to the borrower by check, (c) accumulated and sent to the borrower periodically, or (d) applied to reduce the account.

**21.334** Interest may be charged until the average clearance date of the remittances that are turned over to the lender—for example, a four-day clearance period may be established. Rates charged by commercial finance companies on assigned accounts receivable vary widely (as do rates charged by those commercial banks that engage in accounts receivable financing). The finance company's charge is generally computed as a specific rate per day on the amount of funds advanced, plus in some cases a service fee to compensate for the cost of maintaining the account. Graduated rates may be applied as the account grows larger.

**21.335 Factoring.** In a factoring arrangement, the client actually sells its accounts receivable to the factor. If any of the receivables are uncollectible, the factor suffers the loss and has no recourse to the client. Since this is an outright sale of receivables, the client does not incur any debt. This differs markedly from accounts receivable financing, in which the client merely assigns the receivables to a commercial finance company as collateral for a loan; the client remains responsible for any uncollectible accounts, so that the assignment is termed *with full recourse*.

**21.336** Since the account debtor pays the factor directly, most factors require that the invoice bear a notification legend, such as, "This account has been assigned to and is payable only to the ABC Factors."

**21.337** Nonnotification factoring, however, is available to businesses that sell directly to customers in the retail trade. In this type of factoring, the factor purchases the receivables outright without recourse but does not assume the collection function without specific request. The client makes the collections, and the customer is not notified of the factoring arrangements. The fee for nonnotification factoring may be less than that charged for notification factoring.

**21.338** Factoring costs consist of two elements: an interest charge based on funds advanced prior to the maturity date of the invoices and a commission designed to cover the credit and collection services and protection against losses.

◆

**21.339 Inventory Loans.** When a business has exhausted its ability to borrow on receivables, commercial finance companies may advance funds on inventory under appropriate conditions at a lower percentage of value than on receivables. Three methods exist for financing inventory. The first method, the floating lien, was made possible under the Uniform Commercial Code (UCC). It helped solve the problem of creating a security interest for the lender on a shifting stock of inventory in a debtor's possession. In addition, the UCC made possible the creation of a security interest on property that does not exist at the time but that may come into existence or be acquired subsequently by the person creating the lien. Under this method, an inventory security agreement is negotiated by the commercial finance company (or commercial bank) and the borrower, spelling out in detail the obligation of both parties.

**21.340** Warehouse receipts are commonly used to finance inventory. The borrower delivers goods to a warehouse, which in turn issues a warehouse receipt to the lender. The goods may be placed in either a public warehouse or a field warehouse. A public warehouse is in the business of storing goods for the general public; a field warehouse is one set up at the borrower's place of business. A field warehouse is leased and maintained by a public warehouse, and no one has access to the property placed in it except the authorized employees of the public warehouse.

**21.341** Finally, trust receipts are evidence that certain goods or property to which the lender has acquired title have been released to the borrower in the trust. Title is retained by the lender until sold and accounted for by the borrower. Trust receipts are used in floor planning, which is a form of financing employed frequently by automobile and appliance dealers. The lender advances a percentage of the invoice price of the shipment. As the goods are sold, the borrower must immediately reduce the portion of the loan applicable to the goods sold.

**21.342 Summary.** At one time accounts receivable financing, factoring of receivables, and inventory financing had a stigma attached to them; it was felt that the business resorting to financing of this kind was in trouble and perhaps on the verge of bankruptcy. While some businesses may feel a perfectly legitimate reluctance to engage in receivables financing or factoring, this type of financing is ideal for many concerns. So important is the potential for growth in this industry that larger commercial banks, in certain parts of the country, are rapidly moving into it, through the acquisition or creation of commercial finance divisions.

### **Equipment Financing**

**21.343** Equipment financing can be accomplished through sources other than commercial finance companies and can take several forms. It can involve financing of equipment currently owned by the company, financing of the purchase of new equipment, sale-leaseback financing, or lease financing. Each form of equipment financing may be appropriate at different times and under different conditions.

**21.344 Financing of Currently Owned Equipment.** If a company has equipment that is fully paid for and in good condition, it can often obtain funds by pledging the equipment as collateral for a loan. This is usually accomplished under article 9 of the UCC through the use of a written security agreement on the equipment.





**21.345 Financing of the Purchase of New Equipment.** Manufacturers of new equipment recognize that it is frequently necessary to provide financing arrangements as part of a sales package. Some manufacturers discount the purchasers' notes at their banks. Other manufacturers act as agents for lending institutions offering installment plans as part of the terms of sale. Under installment financing, title is usually retained by the manufacturer until all payments are made. If the purchaser arranges direct installment financing with a financing institution, a lien on equipment is usually taken by the institution.

**21.346 Sale-Leaseback.** The sale-leaseback method of financing has become increasingly popular. Under this arrangement, a company concurrently sells its property to an insurance company or other investor and leases it back to be assured of continued use or occupancy. The lessee obtains needed working capital, and the lessor obtains a lease commitment that assures recovery of the purchase price plus interest for use of the money over the life of the lease.

**21.347 Lease Financing.** The leasing of equipment has become an increasingly important method of financing. Without making a substantial cash payment or incurring a large obligation, a company can acquire the use of equipment by merely committing itself to make a specified number of payments. As a result, the number of leasing companies has grown rapidly in recent years, and banks and insurance companies have entered this field.

**21.348** Any type of equipment can be leased. The lease is usually written on the total customer selling price (including transportation charges and taxes) and is drawn for a period of time. The total amount to be paid is computed by adding finance charges to the total customer selling price.

#### **Other Sources of Funds**

**21.349 Life Insurance Companies.** Life insurance companies are a leading institutional source of long-term debt financing. Corporate bonds and business mortgages represent by far the majority of their investments. However, their fiduciary responsibilities to policyholders and a vast network of state regulations governing their investment policy tend to limit business loans to borrowers of large amounts, generally large corporations, with high credit ratings.

**21.350** Life insurance companies' financing of small businesses is almost exclusively long-term and is done through real estate mortgages. Life insurance companies rarely invest in the bonds of small corporations.

**21.351** Loans on life insurance policies and mortgages of residential property to raise business capital are also, of course, a source of funds provided by life insurance companies.

**21.352 Other Institutional Sources.** Life insurance companies are by no means the only institutional source from which a qualified small business can borrow long-term funds, although the loan policies and practices of life insurance companies establish the character of institutional lending in general. Other institutional sources include fire and other insurance companies, savings banks, pension funds, universities and educational foundations, investment trusts and banks, and charitable organizations.

**21.353 The Small Business Administration.** The Small Business Administration (SBA) is a permanent, independent government agency created by Congress in 1953 to encourage, assist, and protect the interests of small businesses. Congress has directed the SBA to take the lead in identifying and analyzing small business problems, to be the advocate of small business, to foster and coordinate the research and organization of significant data, and to initiate ideas and innovations that will widen opportunities for small businesses to get started and compete on an equitable basis. Among the SBA assistance programs are business loans, direct and immediate participation loans, loan guarantees, economic opportunity loans, and disaster loans.

**21.354 Venture Capital Organizations.** A number of capital sources are directed specifically at new business ventures. Among such sources are private venture capital firms, small business investment companies (SBICs), minority enterprise small business investment companies (MESBICs), and community development corporations (CDCs).

**21.355 Public Ownership.** Various methods exist for exchanging equity in a small business for needed funds. Some of these are employee stock ownership plans (ESOPs), private placements, intrastate security offerings, and offerings covered by the Federal Securities Act.

#### **21.400 HELPING CLIENTS CHOOSE GENERAL LEDGER SOFTWARE**

**21.401** Advising small business clients about choosing new general ledger software can be a profitable engagement for the practitioner and a wise decision for the client. The selection of software begins with an analysis of the accounting needs to be met by the new software and should include an evaluation of the ability of potential software products to meet those needs.

**21.402** Among the major factors to consider in advising an entity on the selection of general ledger software are the following:

- Required capabilities
- Ease of transition
- Ease of training
- Manuals and on-screen help
- Technical support
- Access to user groups
- Security and backup features
- Auditability
- Cost



## Required Capabilities

**21.403** Ensuring that the prospective software will meet the client's needs will naturally be the number one priority. The goal should be to avoid letting the "tail wag the dog," that is, to avoid letting the software limit the usefulness or efficiency of the company's accounting system. Consider the client's needs in the following areas:

- *Internal financial information.* What financial information does management use (or should use) to run their business? Do they track sales by region or product line? Do they use an aging analysis to manage accounts receivable or payables? What information do they need to properly manage their inventory? The software package you choose should not only be able to reliably provide the necessary information, it should also be flexible enough to present it in a way that management can understand it.
- *Financial information for external reporting.* What information, and at what level of detail, is required to prepare GAAP financial statements? How are those financial statements prepared (for example, using the AICPA's ATB software)? What types of supplementary schedules or other specialized reporting requirements must the company comply with? The general ledger software should facilitate the preparation of all reports distributed to third-party users.
- *Budgeting.* Some companies may need the ability to compare actual results to a single budget. They may also need to simultaneously monitor a cash flow or production budget. Other entities use the budgeting capabilities of their software to continually update projected year-end reports. How does the proposed software package meet the company's current or proposed budgeting needs?
- *Consolidation and combining.* Many small businesses have related entities that may currently or in the future have to be consolidated. General ledger software should be able to account for and report on the companies on either a separate company or consolidated basis.

## Ease of Transition

**21.404** Ease of transition includes several factors, such as:

- *Importing.* The new software should have the ability to import from the previous accounting system information such as:
  - Chart of accounts (including the set-up information for cost centers, funds, locations, departments, etc.)
  - Beginning balances
  - Report formats
  - Employee lists and data
  - Vendor lists and data

- Customer lists and data
- Prior year(s) detail, budgets, etc.
- Current year detail, budgets, etc.
- *Availability.* The new software should be available when needed. Usually this is three to four months prior to year-end, to allow for installation, training and three months of parallel operation of both the old and new systems to resolve any transition problems.
- *Similarity to old system.* Any major differences in the level of sophistication between the old and new systems could slow transition. Examples of significantly different features that may prove cumbersome include:
  - Manual system changing to a computerized system.
  - New system may perform some functions that had previously been performed by outside services, such as payroll processing.
  - The look, feel and logic of the new system. If similar to the old system, it will enhance not only training, but also staff and management comfort with the new system, which will facilitate transition.

### **Ease of Training**

**21.405** Training on a new system can be costly in time, money, and staff morale. The degree of similarity to the old system will significantly affect the training required to get the new system up and running. Other factors to consider include:

- *User friendliness.* Even if the new system is complex with a lot of flexibility, menus and entry screens are often designed to match an operator's intuitive approach. User friendliness can be enhanced with:
  - Manuals and on-screen help, discussed below
  - On-screen warnings or reminders of potential problems as or before they become uncorrectable.
  - "Hot keys" or other short cuts to reduce repetitive keystrokes.
- *Training classes.* How often are they given? Are they offered on or off-site?

### **Manuals and On-Screen Help**

**21.406** Manuals and on-screen help should be written in easy to understand language, with insight as to why an operator may need help, what they may have been trying to do that caused them to need help, and what steps they may or may not have tried before they reached the point of needing help.

**21.407** The manuals and on-screen help are as important as the capabilities of the software itself. No matter what capabilities the software has, an operator must be able to use the software relatively unaided most of the time. Even excellent software is useless if operators cannot efficiently use it.

### Technical Support

**21.408** As with any software, support should be available at the hours when operators need help. It should be fairly easy to get through to the support staff, and responses should be relatively fast.

**21.409** Many companies hope to minimize software costs by not paying for support. Often this is false economy, because the cost of support is minimal compared to the cost of confusion or inefficiency.

### Access to User Groups

**21.410** Try to find user groups or other ways for the company to connect with other users. If more than one client uses the same software, it might be possible to have those clients contact each other to discuss the product. Frequently, operators are more comfortable talking to other real users, rather than trainers or support personnel who speak computer jargon. Companies can share examples of how they solved problems or invented new ways to save time and money with the software. The availability of these contacts often provides a comfort level with the software that can not be obtained any other way.

### Security and Backup Features

**21.411** Pay particular attention to security measures and “bells and whistles” when recommending general ledger software to a client. Evaluate the degree of security necessary in the particular organization. For instance:

- If all staff members have a high degree of computer literacy, then multiple levels of passwords and lockouts may be appropriate. For example, non-financial staff should not have access to payroll information, or unauthorized staff should not have access to management meetings.
- If some of the client’s personnel have a relatively low level of computer literacy, then it may be important to have on-screen warnings to require keystroke confirmation for potentially dangerous operations, such as deleting or changing information.

**21.412** Back-up procedures, consistently followed, are essential in any computer system. However, for entities with less computer-literate personnel, *automatic* back-up capabilities become even more important. For example, it may be beneficial:

- To have entries saved automatically every few keystrokes;
- To have “undelete” capabilities; and
- To have a permanent record of deleted/changed transactions.

**21.413** For back-up procedures that are not automatic, it is essential to ensure thorough training in, dependable compliance with, and competent monitoring of those back-up procedures.

### **Auditability**

**21.414** It is in the auditor's best interest to ensure that prospective general ledger software is totally auditable. Additionally, auditability is important for:

- Internal control procedures the client will want to establish, and
- Interim in-house searches for details and problem solving.

**21.415** When selecting general ledger software, look for features such as:

- The ability to print lists of deleted transactions.
- The availability of transaction registers that can be printed out long after a monthly closing is completed.
- The ability to print year-to-date detailed lists and journals, so it is not necessary to review twelve separate monthly lists at year-end.
- Easy verification that one period's beginning balances equal the previous period's ending balances.
- The ability to display any reports on the screen as well as in print.

### **Cost**

**21.416** The cost of prospective software may very well be the least important factor to consider. Many companies feel pressure to minimize such costs, but part of the business consultant's responsibility is to consider the possibility that buying inexpensive software may be a false economy.

**21.417** The cost of "expensive" software is often directly related to the inclusion of the capabilities the client needs:

- Reporting flexibility
- Security provisions
- On-screen warnings of dangerous situations
- "Hot keys" and other provisions to reduce keystrokes and increase efficiency
- On-line, situation-sensitive help screens
- Easy access to support

- A manual that is easy to use and helpful
- Training
- Auditability

**21.418** The cost of “expensive” software can be *inexpensive* compared to avoidable personnel costs resulting from:

- Manually preparing special format reports that inexpensive software cannot produce.
- Reconstructing records because inexpensive software will not reprint prior months reports.
- Incurring avoidable audit costs because year-to-date detail general ledgers or journals cannot be produced.
- Manually preparing interim financial reports for periods that do not coincide with the entity's fiscal year-end.
- Re-entering transactions because inexpensive software does not warn about errors being made.





## CHAPTER 22

### SELF-STUDY COURSE

#### INSTRUCTIONS

##### COURSE OVERVIEW:

This course is designed for auditors who want to learn how to conduct cost-effective and efficient audits in accordance with authoritative pronouncements.

##### GOING THROUGH THE COURSE:

SAS Nos. 31, 45 (AU 313 only), 47, and 55 should be read in their entirety prior to proceeding with this course. Next, you should read the course materials provided, answer the review questions, and then compare your answers to those provided.

##### CPE CREDIT:

To earn a self-study "Certificate of Completion for Recommended Continuing Education Credit" for this course, complete the examination at the end of this Chapter. If you receive a grade of 75% or more on the examination, we will send you a certificate recommending four hours of CPE credit.

#### WARNING

This CPE course was included in the 1994 edition of the *Comprehensive Engagement Manual*. If you have already received CPE credit for completion of that course, you cannot receive additional CPE credit for this course.

Included with the course materials are three postcards. Each postcard will allow you to purchase one examination package (Product No. 730020) which includes the following:

- Self-Study Examination Answer Sheet
- AICPA/CPE Self-Study Course Evaluation
- Preaddressed return envelope, and
- Instruction letter.



Each postcard should be mailed with a check for \$35.00 plus a shipping and handling fee of \$6.00. By purchasing this Manual, up to three persons may obtain four hours of CPE credit for this course.

**Course Code 730020**

### **RESPONSIBILITY FOR KEEPING CPE RECORDS:**

The widely adopted *Statement on Standards for Formal Continuing Professional Education (CPE) Programs* issued by the AICPA, places responsibility on both the individual participant and the course sponsor to maintain a record of satisfactory completion for CPE self-study courses.

You should keep the following information on each course:

- The sponsor-provided Certificate of Completion.
- Other information you feel would be helpful in reporting your CPE credit hours to the state board (e.g., any notes you have taken).

This information should be kept for an appropriate period of time to enable regular periodic reporting to jurisdictional boards of accountancy and to professional organizations requiring such reports. Some state boards request copies of this information directly from registrants. Others will contact the program sponsor to confirm those details provided by CPE participants on a registration form. Sponsors are required to keep documentation on programs for five years.

### **COURSE EVALUATION:**

Included with your examination package will be a Course Evaluation Form, which you should complete and return with your examination answer sheet in the envelope provided. Your comments are important to us for preparing new courses.

### **OBJECTIVES:**

This course will enable participants to:

- Learn how to effectively plan an audit engagement.
- Learn how to apply the two audit approaches used in this Manual — the ABC System and the All-Substantive Approach.
- Determine which of the alternative approaches to use in specific engagement situations.
- Make risk and materiality decisions that result in cost-effective and efficient audit procedures.
- Make sample size selections.

## EFFECTIVE AUDIT PLANNING

Achieving maximum audit efficiency during engagement performance requires making four basic audit planning decisions effectively. These decisions should be made during the planning phase and before the staff begins any work on the engagement:

1. Obtain an understanding of the entity's internal control structure.
2. Determine the level of overall engagement risk, risks of potential misstatements, and the overall materiality limit.
3. Make judgments about the staffing of the engagement, the extent of supervision, and the degree of professional skepticism.
4. Decide on the most cost-beneficial audit approach based on the risk assessment and materiality decisions.

## RISK ASSESSMENT

Planning activities should include assessing two major risk categories; overall engagement risk and risk of potential misstatements.

### Overall Engagement Risk

The basic components of overall engagement risk are:

- Integrity of the client's management
- Use of the financial statements
- Auditability of the entity
- Business environment

Engagements with high overall engagement risk will require more evidence in *all* financial statement classifications to mitigate the high risk. Low risk requires less overall evidence. Overall engagement risk evaluation must be made based on facts that are known to the auditor. Unlike the evaluation of risks of potential misstatements, auditors should not generally speculate about the possibility of risks that *might* occur in the circumstances. The evaluation of overall engagement risk should be documented in a memorandum or in some other manner for each engagement.

**Integrity of Management.** Statement on Auditing Standards (SAS) No. 58, *Reports on Audited Financial Statements*, states, "The financial statements are the responsibility of management." SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*, states, "The auditor neither assumes that management is dishonest nor assumes unquestioned honesty." SAS No. 53 also states, "Management integrity is important because management can direct subordinates to record transactions or conceal information that can materially misstate financial statements."

Any significant matters related to management's integrity, arising during the planning and performance of the audit, should be documented in a special memorandum containing a description of:

- The matters designated for further consideration.
- The risk of material misstatement in the financial statements.
- The additional or changed auditing procedures considered necessary to mitigate such risks.
- The results of performing such procedures and their effects on the audit report.

**Use of Financial Statements.** The risk associated with the use of financial statements is usually high because auditors cannot control their ultimate distribution or the purposes for which users rely on them. The risk is even higher in circumstances such as the following:

- Statements used in legal proceedings.
- Statements used for price-setting in purchases, sales, or mergers.
- Statements of construction contractors submitted to bonding underwriters.
- Statements used to obtain credit.

**Auditability of the Entity.** Although a potential client may request an audit and users of the financial statements may require an audit, certain factors may preclude an auditor from being able to express an opinion on the financial statements. If a client's accounting system does not provide sufficient evidence to support the recorded transactions, or if the client's accounting records have been destroyed or lost, the entity may be unauditible.

For a new client, auditability can usually be determined through discussions with management and the predecessor auditor. The auditor should inquire as to the accounting system and how management determines that the policies and procedures for processing financial information are followed. For a continuing client, auditability is determined by discussions with management as well as through prior experience.

**Business Environment.** The auditor should also consider the business environment in which the client operates. Is the nature of the client's business one which the firm does not have the requisite expertise? Is the client in a financial position where bankruptcy, takeover or merger, or sudden collapse could occur?

### **Effect on Desired Level of Evidence**

Overall engagement risk affects the overall desired level of evidence for all types of tests. When selecting samples for tests of controls (TOCs), for example, overall engagement risk will be a primary reason for using extensive or minimal TOCs. Determination of the nature, extent, and timing of tests of balances will also be affected by overall risk, i.e., high risk will usually require more reliable evidence, larger samples, and performing procedures as of the balance-sheet date. Low risk will permit the opposite. The evaluation of overall engagement risk should be documented in the Planning Memorandum or in some other manner for each engagement.

## **Risk of Potential Misstatements**

This section discusses the nature of the risks of potential misstatements, called audit risk and the impact of such risks on the evidence design process. SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, (AU 312.01) states:

Audit risk and materiality, among other matters, need to be considered together in determining the nature, extent, and timing of auditing procedures and in evaluating the results of those procedures.

Paragraph two of SAS No. 47 (AU 312.02) states:

The existence of audit risk is implicit in the phrase "in our opinion." Audit risk is the risk that the auditor may unknowingly fail to appropriately modify his opinion on the financial statements.

The components of audit risk are:

- **Inherent risk**— An account balance's or class of transaction's susceptibility to misstatement without considering the effects of the internal control structure.
- **Control risk**— The risk that misstatement, exceeding tolerable misstatement, may not be prevented by the internal control structure. In other words, the absence of internal controls or accounting system procedures, or an inadequate control environment, will create risks of potential misstatements.
- **Detection risk**— The risk that the auditor's procedures will lead him or her to conclude that misstatement exceeding tolerable misstatement does not exist, when in fact, it does exist. (Tolerable misstatement is the maximum amount of misstatements, known and unknown, that can exist in the financial statements without causing them to be materially misstated.)

Inherent risk should be identified during planning based on knowledge of the client and its industry. The risk that misstatements will not be prevented from the internal control structure can be determined from the Internal Controls Questionnaire (Chapter 10, section 10.100) and through tests of controls. Potential misstatements also can be identified from the following sources:

- Analytical procedures.
- Prior year's financial statements and notes.
- Prior year's tax returns.
- Obtaining an understanding of the internal control structure.
- Prior year's audit program.
- Prior year's adjustments.
- Prior year's budget.
- Discussions with prior engagement personnel.

- Tour of client's facilities.
- Early examination of minutes.
- Reviewing the correspondence file.

Depending on the nature of the potential misstatements, the extended procedures may include all or part of the procedures for a financial statement classification. For example, if the auditor discovers that a client customarily cuts off recording of sales and collections as of the 25th of each month, the tests of balances for accounts receivable and sales must be expanded. Instead of arbitrarily increasing all tests of balances in this area, the auditor usually will expand only the sales cutoff tests to compensate for this misstatement. Expanded tests would ordinarily include increasing the number of days included in the cutoff test and decreasing the lower limit for testing individual sales transactions.

Detection risk can be controlled through the application of analytical procedures and tests of balances. Knowledge of the client and its industry, and an understanding of its internal control structure, will enable the auditor to assess and plan for the inherent and control risks.

When the risk of potential misstatements is low, the following opportunities for efficiency exist:

- Accumulate less evidence. Less reliable procedures, smaller sample sizes, and interim tests can be performed.
- Assign less experienced assistants to areas where misstatements are least likely to occur.
- Review assistants' work less thoroughly.

As the auditor considers the desired evidence for each financial statement classification, overall engagement risk must be correlated with the risks of potential misstatements. The Risk of Potential Misstatements Evaluation Form in Chapter 10, section 10.101 illustrates an effective way to correlate the risks. The Form is designed on the premise that each engagement has a low risk of potential misstatements. As circumstances causing a high risk of potential misstatements are identified, the Form becomes the source for planning additional tests of balances and analytical procedures to mitigate the risks.

## **ESTABLISHING AND USING OVERALL MATERIALITY LIMITS**

Paraphrasing SAS No. 47, materiality judgments about financial statements are unique to each environment in which judgments are made. Materially misstated financial statements contain misstatements or irregularities that a reasonable person, considering the quantitative and qualitative facts in the circumstances, would consider important enough to cause an unfair presentation.

### **Preliminary Estimate of Materiality (Overall Materiality Limit)**

The preliminary estimate of materiality, or the overall materiality limit, is the maximum amount by which the auditor believes the statements could be misstated, by known or unknown misstatements, and still not affect the decisions of reasonable users. At this time, there is no authoritative literature that establishes materiality percentages. Chapter 2, section 2.329 presents the following guideline percentages and bases:

<u>Materiality Base — Greater of Total Assets or Total Revenues</u>		<u>Percentage of the base</u>	
<u>Over</u>	<u>But Not Over</u>		
\$ 0	\$ 30,000	6.0%	
30,000	100,000	\$ 1,800 + 5.0%	in excess of \$ 30,000
100,000	300,000	5,300 + 3.0%	in excess of 100,000
300,000	1,000,000	11,300 + 2.0%	in excess of 300,000
1,000,000	3,000,000	25,300 + 1.5%	in excess of 1,000,000
3,000,000	10,000,000	55,300 + 1.0%	in excess of 3,000,000
10,000,000	30,000,000	125,300 + 0.5%	in excess of 10,000,000
30,000,000	100,000,000	225,300 + 0.25%	in excess of 30,000,000
100,000,000	300,000,000	400,300 + 0.20%	in excess of 100,000,000
300,000,000		800,300 + 0.15%	in excess of 300,000,000

The overall materiality limit will be used for misstatement analysis purposes and normally will be the largest amount resulting from computations using the bases and percentages above. The overall materiality limit will be compared to the income effects of all known but unadjusted misstatements, projected misstatements, and all estimated misstatements for the current *and* prior year to determine if the financial statements as a whole have an acceptable amount of misstatements.

As the amount of total misstatements approaches the overall materiality limit, there is an increasing likelihood that the financial statements contain unacceptable amounts of misstatements. As total misstatements exceeds some percentage of the overall materiality limit (50% to 80%) most firms require misstatements analysis. Misstatements analysis includes investigating the causes of projected and estimated misstatements to determine additional actual misstatements and, in some cases, extending auditing procedures in the areas of misstatements.

The percentages above presume a stable base and normal relationships between assets and earnings. In the absence of these factors, three or four year's averages, a combination of several bases, or a base relevant to the clients' industry, such as total assets for a financial institution, may be more meaningful.

The rationale for setting the overall materiality limit should be documented in a memorandum or working paper during engagement planning. A Materiality Computation Form is included in Chapter 10, section 10.301 and can be used for documentation purposes.

**Allocating Preliminary Estimate to Segments**

SAS No. 47, paragraph 19 (AU 312.19), states the auditor needs to consider audit risk at the individual account balance or class-of-transactions level because such consideration directly assists him or her in determining the scope of auditing procedures for the balance or class of transactions. Paragraph 17 of SAS No. 47 (AU 312.17) explains, other considerations being equal, either a decrease in the acceptable level of risk or in the materiality limit at the individual account-balance or class-of-transactions level, could require the auditor to select a more effective auditing procedure or to perform auditing procedures closer to the balance-sheet date.

While the pronouncement doesn't require assigning a preliminary estimate of materiality to segments, it may be appropriate to *assign* materiality limits to major financial statement classifications to *measure* misstatements that affect only the balance sheet or the earnings statement. Such assignment could be based on materiality guidelines for each financial statement classification similar to those outlined above. *Allocation* (determining tolerable misstatement amounts) of the overall materiality limit to general ledger accounts is normally only necessary when performing classical variable statistical sampling.

### **Estimating Total and Combined Misstatements in the Segments (Classifications)**

Total misstatements will consist of known but unadjusted misstatements, and projected and estimated misstatements, for the current period *and* the prior period, if such misstatements affect the current period's earnings. The known but unadjusted misstatements will consist of adjustments that, because of their size or other reasons, have not been posted to the trial balance. On small audits where a firm is requested by the client to make numerous housekeeping entries, there may be few known but unadjusted misstatements. On the other hand, engagement efficiencies can result when these small adjustments are passed on working papers or a summary schedule to avoid posting to the trial balance and working papers. The Summary of Possible Journal Entries Form in section 10.302 illustrates such a schedule.

Projected or estimated misstatements may result from sampling procedures, analytical procedures, and non-sampling procedures. Inventory pricing misstatements in a sample, or a sales-cutoff misstatement revealed during the year-end cutoff tests, are examples of misstatements that should be projected to the sampling population. The total of the projected, estimated, and known misstatements can be summarized on the Summary of Possible Journal Entries Form for comparison and compared to the corresponding financial statement amounts and to the overall materiality limit.

### **Comparing the Combined Estimate of Misstatements to the Overall Materiality Limit**

While the preliminary materiality estimate is not cast in concrete, it is the tool by which the auditor measures the sufficiency of his or her work. If sampling risk, i.e., the risk the population will have more misstatements than the sample, is high when the auditor uses nonstatistical sampling, misstatements approaching, or in excess of, the overall materiality limit should alert the auditor to reconsider the nature of the misstatements, the conditions they represent, and the overall results of the auditor's work. The auditor has several alternatives:

- Change the preliminary estimate of materiality.
- Request the client make adjustments for some or all of the actual misstatements.
- Consider the nature of the projected or estimated misstatements to isolate *causes* for further investigation and corrective action.
- Expand auditing procedures in the areas that resulted in large amounts of projected or estimated misstatements.



While the auditor might be tempted to change the preliminary estimate of materiality, doing so will usually not be appropriate. The overall materiality limit was established to help control the amount of misstatements in the financial statements and, unless special, unusual circumstances warrant, it usually should not be changed to accommodate the results of the auditor's procedures. Most commonly, the auditor's evaluation will result in some combination of making adjustments for actual misstatements and "carving out" the causes of projected and estimated misstatements. From an efficiency standpoint, the last thing the auditor wants is to increase sample sizes and perform more procedures. However, if the misstatements noted requires additional tests, they should be performed. The in-charge and engagement partner should confer before requesting client personnel to investigate or recheck their work.

Good misstatements analysis includes consideration of both the misstatement itself *and* the condition it may represent. In other words, the auditor must consider not only the quantitative effects of misstatements, but also their qualitative effects. Qualitative factors may cause small, seemingly isolated misstatements to have a material effect on the financial statements as a whole. The following are some qualitative factors that should be considered when evaluating misstatements:

1. Related-party transactions.
2. Misstatements resulting from conflicts of interest.
3. Misstatements arising from irregularities or illegal acts.
4. Misstatements that could be material in the future.
5. Misstatements with financial statement impacts, e.g., changing earnings from a small profit to a loss or changing cash in bank to an overdraft.
6. Misstatements symptomatic of larger problems, e.g., numerous sales returns, extensive product warranty claims.
7. Misstatements affecting contractual obligations such as covenants in debt agreements.

### **Time-Savings Opportunities**

The concepts of materiality included in SAS No. 47 provide a framework for audit quality. They also provide opportunities for saving time. Here are a few:

1. The overall materiality limit will affect sample sizes determined statistically or nonstatistically. Using the largest base for the computation (instead of the smallest, as is the practice of many firms) results in smaller sample sizes and less work to achieve the desired level of assurance.
2. A factor of the overall materiality limit, usually one-third to one-half, can be used as the lower limit for individually significant items. One-third would be used when overall engagement risk or audit risk is high; one-half would be used when such risks are low. Account balances on the trial balance, individual sample populations, and outstanding checks on bank reconciliations that are less than the lower limit are examples of details that could be excluded from testing.
3. Potential adjustments that are less than the lower limit for individually significant items can be recorded on the Summary of Possible Journal Entries Form in section 10.302 for misstatement analysis purposes, thereby limiting the number of adjustments to the trial balance.



## Risk and Materiality Summary

Risk and materiality assessment and evaluation are the vital elements affecting the optimum mix of evidence that will produce both quality and efficiency on audit engagements of all sizes. Overall engagement risk will subjectively affect the *overall* level of evidence. Identifying risks of potential misstatements will affect the level of evidence in *specific* accounts or financial statement classifications. Setting the overall materiality limit will enable the auditor to concentrate on major problems and financial statement areas. The professional judgment of the auditor in each engagement's circumstances, considering risks and materiality, will produce both quality and efficiency.

## OVERVIEW OF AUDIT APPROACHES

### Overview of ABC System

The ABC System is a unique approach to planning and performing an audit, in that it is designed to allow the auditor to assess control risk for each of the major audit areas of an entity, and to provide the auditor with the tests of controls, tests of balances, and analytical procedures most likely to be relevant to each major audit area.

The ABC System is based on the assumption that the auditor may determine that it is more efficient to perform tests of controls for some or all major audit areas in order to reduce substantive testing while maintaining high audit quality and complying fully with all generally accepted auditing standards.

The ABC System's Internal Controls Questionnaire (Chapter 10, section 10.100) is organized into three levels of priorities (for each major audit area):

- those controls necessary to provide the client with an effective basic accounting system (level C),
- those controls necessary to provide the client with both an effective accounting system and good primary controls (levels B and C acting together), and
- those controls necessary to provide the client with good secondary controls, as well as good primary controls and an effective accounting system (levels A, B, and C acting together).

By completing the entire Internal Controls Questionnaire, the auditor can assess the controls for each major audit area. The auditor can then exercise judgment to determine that:

- a major audit area for which all (or substantially all) controls in the A, B, and C levels are present would qualify as an "A System," for which the auditor could assess control risk as low or moderate (which would justify minimizing substantive tests once the controls themselves are tested),
- a major audit area for which all (or substantially all) controls in the B and C (but not the A) levels are present would qualify as a "B System," for which the auditor could assess control risk as moderate to slightly below the maximum (which would justify reducing some substantive tests once the controls are tested), or

- a major audit area for which all (or substantially all) controls in the C level (but not the A and B levels) are present would qualify as a "C System," for which the auditor could assess control risk as maximum to slightly below maximum (which would cause the auditor to perform primarily substantive tests in most cases, even after the controls are tested).

The Reliance Matrix on page 22-13 portrays the interrelationship of control risk and degree of reliance on controls for systems classified as A, B, or C.

Audit programs for tests of controls and tests of balances can be designed according to whether controls over a major audit area are determined to constitute an A System, a B System, or a C System. Each major audit area must be assessed and classified independently from other major audit areas; thus, the payroll cycle may be classified as an A System, the payments and acquisitions cycle may be classified as a B System, and the sales and revenue cycle as a C System. Of course, an auditor must use his or her understanding of the client and the client's industry to customize the precise audit program for an engagement, but the ABC System helps the auditor determine appropriate and justifiable levels of substantive testing without "overauditing" or "underauditing."

The ABC System incorporates analytical procedures to the maximum extent possible, whether a system is rated as A, B, or C, in order to obtain the optimal mix of audit evidence for quality and efficiency.

### **Overview of All-Substantive Approach**

**The Approach.** The All-Substantive Approach presumes that the auditor obtains an understanding of the internal control structure sufficient to plan the audit (see page 22-14) and assesses control risk at the maximum. The approach assumes that minimum tests of controls will be performed and that analytical procedures and substantive tests will be used extensively.

There are two ways in which an auditor may come to the decision to assess control risk at the maximum for all major audit areas: elective and forced.

**Elective Use of the Approach.** If the client's operations and financial statements are noncomplex, an auditor may decide that substantive testing can easily provide all the evidential matter needed for him or her to express an opinion on the financial statements.

For this type of client, the auditor may decide to "artificially" assess control risk at the maximum for all major audit areas to avoid the inefficient use of audit time, to test the internal control structure, and to perform an all-substantive audit.

The All-Substantive Approach Questionnaire (Chapter 10, section 10.200) can be used by an auditor to document his or her understanding of the client's internal control structure. By using this Questionnaire, an auditor may bypass the two ABC System steps of completing the Internal Control Questionnaire and performing extensive tests of controls. However, performing limited tests of controls is recommended to enhance the auditor's understanding of the internal control structure and the flow of transactions through the accounting system. Completing some or all of the System C Test of Controls Programs can satisfy these objectives.

**Forced Use of the Approach.** The auditor does consider controls over each major audit area and determines that control risk in fact should be assessed at maximum, due to absent or faulty controls or due to inadequate compliance with the controls that ostensibly are in place. Such situations would call for the forced use of the All-Substantive Approach, unless or until the auditor determines that the client records are not auditable, which would require a scope limitation or withdrawal from the engagement.

## **SELECTING THE AUDIT APPROACH**

The most appropriate audit approach is one or a combination of several approaches, which will verify all financial statement assertions applicable to each financial statement classification, in the least amount of time, in each engagement's circumstances, each year. The auditor's decision is based, essentially, on whether a client has an adequate internal control structure to test for a reduction in control risk and, if such tests can be performed, whether such tests will be the most efficient approach to gathering the evidence necessary for the desired level of assurance.

From an efficiency standpoint, the lower the level of control risk, the less work will normally be necessary to reach the desired level of assurance. For example, when a client's internal control structure is strong, the auditor's approach will normally include testing the internal controls to reduce control risk. The time spent on such testing is usually recovered many times over through corresponding reductions of the detailed tests of balances. On the other hand, if the tests of details of account balances can be performed in less time than testing controls, minimum internal control documentation will be prepared.

We have four basic alternatives for the approach:

1. Extensive tests of controls and analytical procedures with minimal tests of balances.
2. Moderate tests of controls and extensive analytical procedures and moderate tests of balances.
3. Extensive tests of balances and analytical procedures with minimal tests of controls.
4. Extensive tests of balances and analytical procedures with little or no testing of controls.

These alternatives to selecting an audit approach can be illustrated on the following matrix:

**RELIANCE MATRIX**

Reliance on Types of Tests Based on Control Risk Assessment

<u>Audit Approach</u>	<u>Control Risk</u>	<u>Tests of Controls</u>	<u>Analytical Procedures</u>	<u>Tests of Balances</u>
<b>ABC System:</b>				
System A: Good Control Procedures	Low to Moderate	High Reliance	Maximum Extent Possible	Low Reliance
System B: Good Accounting System and Primary Controls	Moderate to Slightly Below the Maximum	Moderate Reliance	Maximum Extent Possible	Medium Reliance
System C: Good Accounting System or More Efficient Substantive Test Approach	Slightly Below the Maximum to Maximum	Low or No Reliance	Maximum Extent Possible	Slightly less than High to High Reliance
<b>All-Substantive Approach:</b>				
Weak Accounting System or More Efficient Substantive Test Approach (System C Tests Of Controls)	Slightly Below the Maximum to Maximum	Low or No Reliance	Maximum Extent Possible	Slightly less than High to High Reliance

The alternatives in this matrix can be applied by transaction cycle, i.e., payments and acquisitions, sales and collections, and payroll, for maximum efficiency. The auditor may choose, for example, to perform controls, testing of controls, and limited tests of balances for accounts from the payments and acquisitions cycle while performing no testing of controls, and extensive tests of balances, for the payroll and sales and collections cycles.



## The Internal Control Structure

The internal control structure is comprised of three parts: the control environment, the accounting system, and control procedures.

The accounting system is comprised of the accounting records and the recordkeeping procedures necessary to *prepare* reliable financial information. The control procedures consists of procedures that *check* the operation of the accounting system. It is, obviously, possible for a client to have a good accounting system and, at the same time, limited or nonexistent control procedures.

The control environment consists of managements' attitudes and other factors that may significantly impact the design and effectiveness of an entity's specific control procedures and the operation of the accounting system. The internal control structure, described in SAS No. 55 (AU 319), *Consideration of the Internal Control Structure in a Financial Statement Audit*, looks like this:

### ELEMENTS OF THE INTERNAL CONTROL STRUCTURE

For a financial statement audit, an entity's internal control structure comprises the following:

**Control Environment:** The collective effect of various factors on establishing, enhancing, or mitigating the effectiveness of specific policies or procedures. The control environment includes such factors as—

- Management's philosophy and operating style.
- The entity's organizational structure.
- The functioning of the board of directors and its committees, particularly the audit committee.
- Methods of assigning authority and responsibility.
- Management's control methods for monitoring and following up on performance, including internal auditing.
- Personnel policies and practices.
- Various external influences that affect an entity's operations and practices, such as examinations by bank regulatory agencies.

The control environment reflects the overall attitude, awareness, and action of the board of directors, management, owners, and others concerning the importance of control and its emphasis in the entity.

**Accounting System:** The methods and records established to identify, assemble, analyze, classify, record, and report an entity's transactions and to maintain accountability for the related assets and liabilities. An effective accounting system will give appropriate consideration to establishing methods and records that will—

- Identify and record all valid transactions.
- Describe on a timely basis the transactions in sufficient detail to permit proper classification of transactions for financial reporting.

- Measure the value of transactions in a manner that permits recording their proper monetary value in the financial statements.
- Determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period.
- Present properly the transactions and related disclosures in the financial statements.

**Control Procedures:** Those policies and procedures, in addition to the control environment and the accounting system, that management has established to provide reasonable assurance that specific entity objectives will be achieved. Control procedures pertain to—

- Proper authorization of transactions and activities.
- Segregation of duties to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or irregularities in the normal course of his or her duties— assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets.
- Design and use of adequate documents and records to help ensure proper recording of transactions and events, such as monitoring the use of prenumbered shipping documents.
- Adequate safeguards over access to and use of assets and records, such as secured facilities and authorization for access to computer programs and data files.
- Independent checks on performance and proper valuation of recorded amounts, such as clerical checks, reconciliations, comparisons of assets with recorded accountability, computer-programmed controls, management review of reports that summarize the detail of account balances (for example, an aged trial balance of accounts receivable), and user review of computer-generated reports.

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SAS No. 55 requires an auditor to obtain and document the understanding of the three elements of the internal control structure. Additional narratives and flowcharts may be useful on larger, more complex engagements.

**Documentation.** Documentation of the understanding of the internal control structure is required by SAS No. 55. The documented understanding can be updated from year to year.

For most smaller businesses, the control environment can be efficiently documented by a simple organizational chart and a few written paragraphs about responsibilities for authorizing transactions and about management's role in the control environment. Documentation of the flow of transactions in the accounting system may be a bit more extensive. The auditor needs to identify the methods by which significant classes of transactions are authorized, executed, and recorded, including the methods of data processing.

The flow of transactions can be documented by narrative description, an elementary flowchart, or a specially-designed form.



## Tests of Controls

Tests of controls are performed to measure the likelihood of misstatements resulting from the internal control structure, to reduce control risk, and to reduce the amount of and tests of balances. Tests of controls consist mainly of observations, inspections, inquiries, and recomputation. Examining a foreman's initialed approval of hours worked on employees' time cards, for example, is a test of control. Materiality is measured by the frequency of deviations.

A controls test of the accounting system is designed to test for monetary errors and recordkeeping procedures. Determining that all entries recorded in the cash disbursements journal are valid by examining supporting documents, or that the extensions of sales prices and units on sales invoices are correct, are examples of controls testing. Materiality is measured by the frequency, or rate, of misstatements.

## Analytical Procedures

Most analytical procedures are corroborative in their nature. Their primary purpose is to corroborate evidence gathered from other tests designed to verify financial statement assertions. When high reliance is placed on analytical procedures, related tests of balances can be reduced and significant efficiencies created. The extent of the reductions of tests of balances depends on the effectiveness of the analytical procedure.

Determination of the effectiveness of a procedure must be based on the procedure's contribution to verification of the financial statement assertions. To say it another way, the most effective analytical procedures are those that, by themselves, substantially verify all the applicable financial statement assertions for an account balance. Computations designed to predict the balance in a general ledger account are normally the most effective analytical procedures. Examples of analytical procedures, in the order of their effectiveness, are:

### 1. Quantity Reconciliations:

Multiplying the number of units sold times sales price, or the number of employees times weekly or monthly salaries, reconciling inventory quantities from the beginning to the end of the year, and other similar procedures can, by themselves, substantially verify all the financial statement assertions for the applicable general ledger account. Few, if any, other tests would be necessary for the affected accounts.

To achieve maximum effectiveness, the reliability of the underlying data for these procedures must, of course, be established by other tests. For example, performing a quantity reconciliation for copy sales by a quick-copy business would simply require multiplying the number of copies sold times the copy sales price and considering a historical scrap allowance. The number of copies could be obtained from the client's copy log; however, the auditor would have to physically obtain beginning and ending numbers from the meter to establish the reliability of the log. To determine the meter reading has not been altered, the auditor may also decide to trace the number of copies to billings for copy machine rentals from the supplier.



## 2. Reasonableness Tests:

Depreciation computations performed by computing depreciation by financial statement classification and method, based on average lives and one-half year for additions and disposals, is an example of a reasonableness test. Computing interest expense based on average note balances and interest rates is another example.

Different from quantity reconciliations, reasonableness tests are based on averages and estimates. Reasonableness tests are, therefore, not as effective as quantity reconciliations. Other limited tests of controls or balances may be necessary to complete the verification of the assertions for material account balances.

## 3. Corroborating Procedures:

The most common analytical procedures, such as absolute dollar comparisons and ratio analyses, provide evidence that corroborates other tests of controls and balances. While greater reliance on corroborating procedures designed at a low level of detail, such as by division or product line, will enable the auditor to restrict the nature, extent, and timing of the tests of balances procedures, the degree of the tests of balances evidence reductions will depend on the engagement risks. Even when the engagement risks are low, certain minimum tests of balances procedures will still be necessary for satisfactory verification of the financial statement assertions.

Analytical procedures must be applied during planning to help identify problems and during engagement completion to corroborate the results of completed work. Minimum analytical procedures performed during planning on small business audits may consist solely of comparisons of current unadjusted account balances with the prior year.

Placing high reliance on analytical procedures requires, simply, that all variances be investigated and resolved. From the investigation, the auditor may determine that the variance is not indicative of a problem or, on the other hand, that it is caused by an error or conditions that could cause other misstatements in financial information. The auditor may, or may not, determine that adjustments are necessary.

### **Tests of Balances**

Substantive tests of the balances of general ledger accounts include, among other evidence collection procedures, the following:

- Physical inspection of assets.
- Confirmation of account balances.
- Documentation of support for balances.
- Observation of the work of client personnel.
- Inquiries of the client.
- Recomputations of mechanical accuracy of balances.

The substantive tests of balances normally make the most substantial contribution to verification of financial statement assertions. The larger the engagement, the higher are the costs of tests of balances. As shown in the Reliance Matrix (on page 22-13), when the client has good control procedures or a good accounting system, high reliance on tests of balances is not normally the most efficient evidence collection approach. On some smaller engagements, however, small populations may be audited in the least amount of time by placing high reliance on tests of balances. Even though a small client may have a good accounting system, the auditor should select the audit approach that is the most efficient in each engagement's circumstances.

Illustrated below are some ways that substantive tests of balances may be reduced when the ABC System is used.

### **REDUCTIONS IN SUBSTANTIVE TESTS OF BALANCES**

<u>Audit Areas</u>	<u>Possible TOBs Reductions</u>
1. Cash	1. Prove fewer bank reconciliations. Prove some reconciliations at dates other than balance-sheet date. Trace fewer reconciling items to support. Use client's subsequent bank statement instead of cutoff statement.
2. Accounts receivable confirmation and alternative procedures for nonreplies and exceptions	2. Send fewer confirmations. Confirm at interim dates. Alternative procedures for nonreplies to positive requests should consist of reviews of subsequent collections. Absent subsequent collections, and in the event of numerous nonreplies, sales and shipping documents should be examined.
3. Sales cutoff	3. Select fewer sales items for testing.
4. Physical inventory observation <sup>1</sup>	4. Fewer test counts taken and recorded. More time spent determining client is following instructions. Less time spent on observation. Observe cycle counts for perpetual systems.
5. Tests of balances inventory pricing and clerical tests <sup>1</sup>	5. Select fewer inventory items for testing.
6. Vouching and inspecting fixed assets	6. Less physical inspection of assets. Limit the extent of vouching tests for additions, repairs, supplies, etc., especially when numerous, low value assets have been capitalized.
7. Search for unrecorded liabilities	7. Higher dollar limits for review of journals, open invoices, receiving reports and purchase order files. Few, if any, vendor confirmations would be sent.

<sup>1</sup> When client's inventory system is nonperpetual, controls testing of inventory cannot be performed. Observation procedures, pricing, and clerical tests are primarily substantive tests of balances, the extent of which depends on how well client personnel follow written instructions and on the extent of the client's double-checking procedures.

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**REDUCTIONS IN SUBSTANTIVE TESTS OF BALANCES (Continued)**


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<u>Audit Areas</u>	<u>Possible TOBs Reductions</u>
8. Purchases cutoff	8. Select fewer purchase items for testing.
9. Payroll tests	9. Eliminate monthly or periodic comparison of payroll. Eliminate reconciliation of payroll-to-payroll tax returns.
10. Expense account analysis and vouching	10. Select fewer expense items for testing.

**THE All-SUBSTANTIVE APPROACH**

A small audit engagement is characterized by some or all of the following characteristics:

1. Concentration of operational control in the hands of one or a few individuals.
2. Management personnel or employees have limited accounting knowledge.
3. Management believes that it cannot or need not hire employees having accounting knowledge.
4. The potential for management override of internal accounting controls is high.
5. Internal control deficiencies result from:
  - a. Limited segregation of functions within the accounting system because of the small number of employees.
  - b. Easy access to physical assets by clerical and administrative personnel.
  - c. Informally designed procedures for planning, budgeting, accounting, and reporting depend on management style.
6. The entity has an inactive or ineffective board of directors.

The majority of small and medium size entities possess some or all of these characteristics, making it necessary for the auditor to perform extensive tests of balances to compensate for unacceptable results of tests of controls.

An auditor may elect to use the All-Substantive Approach on an engagement if he or she decides that such an audit approach would be the most efficient approach. In other words, the nature of the entity's internal control structure may make performing substantive tests more cost effective than tests of controls. This approach involves assessing control risk at the maximum or slightly below the maximum for all major audit areas. Under this approach, minimal tests of controls are performed and extensive tests of balances and analytical procedures are performed. Even though tests of controls are not required whenever control risk is assessed at the maximum, this approach provides for minimum controls tests through completion of the

System C Tests of Controls Programs. Performing these minimum tests of controls is recommended because they can enhance the auditor's understanding of the control structure and flow of transactions through the accounting system, and also allow the auditor to slightly reduce substantive tests.

### **Tests of Controls**

Even though tests of controls are not required when control risk is assessed at the maximum, the All-Substantive Approach requires minimum tests of controls, using the System C Tests of Controls Programs, to enhance the auditor's understanding of the control structure and flow of transactions. Performing the System C tests of controls may also support an assessment of control risk at slightly below the maximum, allowing the auditor to achieve a slight reduction in tests of balances. The System C Tests of Controls Programs should be selected for all audit areas. Minimum sample sizes may be selected, because minimum reliance is being placed on the tests of controls.

### **Analytical Procedures**

As for all audit engagements, analytical procedures should be performed on the All-Substantive Approach to the maximum extent practical and should be performed as early in the engagement as possible. On engagements where significant adjustments are required, analytical procedures should be performed after all significant adjustments have been recorded. In each circumstance, the planned reliance on analytical procedures should be reflected in the modification of the Tests of Balances Program.

### **Tests of Balances**

Because minimum or no tests of controls are performed in a System C, substantive tests become the primary source of evidence. The nature, timing, and extent of the tests of balances and analytical procedures selected should be those that are the most reliable, e.g., positive vs. negative confirmations, larger sample sizes, and tests should be performed at year end rather than at interim dates. The Table below presents some suggestions that should be considered in designing high-reliance tests of balances for major audit areas.

**ALL-SUBSTANTIVE APPROACH  
SUGGESTED TESTS OF BALANCES**

<u>Major Audit Area</u>	<u>Program Design Consideration</u>
1. Cash	1. Prove all major bank reconciliations at the balance-sheet date. Trace most reconciling items to cutoff statements. Search extensively for unrecorded bank transfers.
2. Accounts receivable confirmation and alternative procedures	2. Send positive confirmations for representative accounts comprising a substantial portion of the account balances at year end in accordance with SAS No. 39.  Support nonreplies and exceptions by reference to sales and cash receipts documents. Compare sales by month, by product, to preceding years. Follow up on significant fluctuations by inspecting underlying records.
3. Sales cutoff	3. Perform extensive cutoff tests by reference to sales and shipping documents for a large period before and after the balance-sheet date.
4. Physical inventory observation	4. Consider observing inventory from start to finish. Make extensive test counts at all locations.
5. Inventory pricing and clerical tests	5. Perform extensive, representative tests in accordance with SAS No. 39. A significant portion of the inventory items should be subjected to tests.
6. Vouching and inspecting fixed assets	6. Perform extensive vouching and inspections. A significant portion of the fixed assets, repairs, supplies, etc., accounts balances should be subjected to tests.
7. Search for unrecorded liabilities	7. Perform an extensive search for unrecorded liabilities including subsequently recorded transactions, open invoices, receiving reports and purchase order files. Low dollar limits should be used. Consider confirming major suppliers, including zero balances.
8. Purchases cutoff	8. Perform extensive cutoff tests by reference to vendor invoices for a large period before and after the balance-sheet date.
9. Payroll tests	9. Compare monthly payroll by labor category and follow up on transactions by reference to underlying records. Consider predictive analytical procedure or reconciling gross wages to payroll tax returns. Consider observation or payroll distribution.
10. Expense account analysis and vouching	10. Perform extensive vouching tests for all significant account balances by examining canceled checks and supporting documents.

## SELECTING PROCEDURES CONSISTENT WITH AUDIT APPROACH

The following Evidence Matrix illustrates the impact of a client's internal control structure, and the related audit approach, on the tests of balances evidence:

### EVIDENCE MATRIX

Audit Approach	Control Risk for Most Financial Statement Assertions	Substantive Tests of Balances Evidence			
		Amount	Nature	Extent	Timing
<b>ABC Approach</b>					
System A: Good Control Procedures	Low	Small Amounts	Least Reliable	Small Samples	Most Precede Year End
System B: Good Accounting System and Primary Controls	Moderate	Medium Amounts	More Reliable	Medium Samples	Some Precede Year End
System C: Good Accounting System	Slightly Below the Maximum to Maximum	Large Amounts	Most Reliable	Large Samples	Most at Year End
<b>All-Substantive Approach</b>					
Weak Accounting System or More Efficient Substantive Test Approach	Slightly Below the Maximum to Maximum	Large Amounts	Most Reliable	Large Samples	Most at Year End

Control risk varies inversely with the level of controls in a client's internal control structure. Because the risks result from weaknesses in the internal control structure, the absence of certain controls or procedures results in higher risks. The risks will, of course, be assessed by transaction cycle and related to the general ledger accounts evolving from each cycle. Weaknesses in the sales and collections cycle, for example, will affect the audit of the cash, accounts receivable, and sales accounts.

As illustrated in the Evidence Matrix above, reductions in tests of balances occur in the nature, extent, and timing of procedures. Overauditing can easily occur if the auditor selects the *most* reliable test of balances procedure when the auditor is planning *low* tests of balances reliance. On the other hand, insufficient evidence can result if less reliable tests of balances procedures are used when the auditor plans extensive tests of balances.

Auditor-generated evidence is usually considered the most reliable. Inspections, observations, and recalculations are examples of procedures that provide auditor-generated evidence.

Evidence from external sources normally is the next most reliable. Direct correspondence with customers or vendors, or inspections of vendor statements or invoices, produce such evidence.

Internal evidence, such as sales invoices, is generally the least reliable form of evidence. When considering the reliability of tests of balances, the auditor should first consider the planned evidence mix as illustrated on the Reliance Matrix and then select the procedures that take the least amount of time. In other words, the auditor may be able to achieve a given level of assurance with large amounts of internally-generated evidence, but it could take excessive amounts of time. Depending on the engagement circumstances, high-reliability evidence, such as auditor-generated procedures or third-party confirmations, may be more efficient.

## OTHER PROCEDURAL CONSIDERATIONS

### Arithmetic Accuracy Tests

To adequately verify financial statement assertions, the summarization and transfer of transactions to the general ledger must be tested for arithmetic accuracy. Depending on the size of the client, and the possibility of intentional misstatements of journals and subsidiary records, the arithmetic accuracy tests can be limited. Tracing totals of source journals to the general ledger and subsidiary ledgers will, of course, be more extensive when the auditor plans to rely on the results of tests of controls. If the auditor plans high reliance on tests of balances and analytical procedures, the arithmetic accuracy tests may be limited to such procedures as footing the primary column in source journals, tracing a few column totals to the general ledger, and tracing a small number of recorded entries to the subsidiary ledgers.

### Verification of Completeness Assertion

SAS No. 31, *Evidential Matter*, (AU 326) outlines the financial statement assertions that are the representations of management:

- Completeness
- Valuation or allocation
- Existence or occurrence
- Rights and obligations
- Presentation and disclosure



The audit objective is to verify these assertions for all material financial statement items. Control tests are usually the most cost-efficient means for verifying the assertions. If adequate control tests are not performed, most of the assertions can be adequately verified by tests of balances procedures. The exception is often the completeness assertion for revenues.

Determining that all transactions are recorded (completeness) can usually be verified in the least amount of time with tests of controls. If tests of controls are not performed, tests of balances or analytical procedures must include tests of completeness. Proving bank reconciliations, sales and purchases cutoff tests, inventory observations, and searches for unrecorded liabilities are examples of tests of balances that verify completeness. Predictive analytical procedures, such as quantity reconciliations and reasonableness tests discussed above, also may verify the completeness assertion and they are, of course, much more efficient than other types of tests. For the financial statement classifications for revenues, however, the completeness assertion is more elusive.

The completeness of revenues usually can only be adequately verified by control tests or some form of predictive analytical procedures. The AICPA's Audit Research Monograph Number 5, *Audit Problems Encountered in Small Business Engagements*, pointed out that failure to verify *all* assertions for *all* material financial statement classifications could cause a scope limitation resulting in an opinion qualification or disclaimer. For revenues of small businesses, it may be necessary to perform *limited* tests of sales transactions to verify completeness even though the auditor plans high reliance on tests of balances for other financial statement items.

### **Audit Program Modification**

Overauditing frequently results from using standard audit programs. While an in-charge may be instructed to modify standard programs for each client, time pressures often cause the standard procedures to be performed on each engagement. To maximize efficiency, the auditor should perform no procedure without a reason. Standard programs must be modified to prevent overauditing.

Even when standard programs are modified for the first-year audit of a client, changes are rarely made in subsequent years. Changes in client circumstances, and in auditing and reporting requirements, should be reflected in audit program modifications each year.

## **DECIDING TO SAMPLE OR NOT TO SAMPLE**

**Notice to participant: Read section 3.500 of the Manual.**

## **SUMMARY — MAKING THE FOUR BASIC AUDIT PLANNING DECISIONS EFFECTIVELY**

As identified in the previous planning discussions, the four basic audit decisions (page 22-3) must be reviewed by the engagement partner before staff begins the field work. The partner is, in fact, the catalyst for effective decision-making. The partner's understanding of these concepts and applications is the key to maximum audit profitability. Making these decisions an integral part of planning, and of the supervision and review process, will insure high quality engagements at the lowest possible costs.



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## AUDIT PLANNING MEMORANDUM

The Audit Planning Memorandum is the culmination of the planning process and should be prepared for all audit engagements. It is the catalyst of achieving both engagement quality and profitability. The memorandum should be prepared by the engagement in-charge and approved by the engagement partner before engagement personnel begin the field work. It can be prepared using the form in Chapter 10, section 10.300 or in a handwritten or typed narrative.

## THE PLANNING MATRIX

The Planning Matrix (see Chapter 10, section 10.103) helps the auditor select the proper mix of audit procedures and sample sizes under the ABC System. It is based on the evaluation of the risk of potential misstatements and the assessment of control risk. The Planning Matrix should be completed by the in-charge and approved by the engagement partner after the following documents have been finalized:

1. Client Acceptance and Continuance Form.
2. Audit Planning Memorandum.
3. Internal Controls Questionnaire
4. Risk of Potential Misstatements Evaluation Form.



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**REVIEW QUESTIONS**

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1. Describe the two major engagement risk categories, their components, and the effect each risk category has on the nature, extent, and timing of evidence.

a. Overall Engagement Risk: \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

b. Risk of Potential Misstatements (Audit Risk): \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

2. Define overall materiality limit, tolerable misstatement amount, and how the two concepts differ.

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\_\_\_\_\_  
\_\_\_\_\_

3. Refer to the Working Trial Balance and Summary of Possible Journal Entries Form for ABC Company on pages 22-33 through 22-35:

a. Using the guidelines in the reading materials, compute the overall materiality limit. \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

b. Based on the overall materiality limit and the potential misstatement amounts, are the misstatement results acceptable? Why or why not? \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

c. If the auditor assumes the misstatement amounts are unacceptable, what additional procedures may be necessary? \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

**REVIEW QUESTIONS (Continued)**

d. As projected misstatements from the current and prior year on the Summary of Possible Journal Entries Form approaches the overall materiality limit, at what point should the auditor take corrective action? Why? \_\_\_\_\_

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e. Describe, in your own words, the purpose of establishing an overall materiality limit during planning. \_\_\_\_\_

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 \_\_\_\_\_

4. To maximize efficiency, the auditor should select an audit approach and auditing procedures that will verify all financial statement assertions without overauditing. What factors influence the selection of an audit approach? \_\_\_\_\_

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 \_\_\_\_\_  
 \_\_\_\_\_  
 \_\_\_\_\_

5. Following on pages 22–29 through 22-32 is a brief description and limited financial information for the Porous Precast Company:

a. Referring to the Reliance Matrix on page 22-13, describe the basic audit approach you would select and why it should be the most cost efficient. \_\_\_\_\_

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b. Would you use the same approach for all transaction cycles? Why or why not? \_\_\_\_\_

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 \_\_\_\_\_



**REVIEW QUESTIONS (Continued)**

6. Describe the basic types of tests (TOCs, APs, or TOBs) and the general nature, extent and timing of the tests of balances you would perform, and why you would use them, to collect sufficient but not excessive evidence in the following circumstances:

a. Sales and collections cycle. The internal control structure is good in the sales and collections cycle. Overall engagement risk is low, but the risk of potential misstatements in accounts receivable and sales is high because the regular accounts receivable clerk takes vacation the last two weeks of each fiscal year. The clerk's duties are performed by two office secretaries in his absence. \_\_\_\_\_

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\_\_\_\_\_  
\_\_\_\_\_

b. Payments and acquisitions cycle. The accounting system is good in the payments and acquisitions cycle. Other internal controls are limited. There are no significant risks of potential misstatements, but overall engagement risk is high because the client is in a start-up phase and the financial statements will be used by a bank for establishing a credit line. \_\_\_\_\_

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

c. Payroll cycle. The accounting system for payroll is the bare minimum required for compliance with IRS regulations. The client is small and has 12 to 15 employees year-round. Overall engagement risk is low. Because pay rates and hours worked are similar from period to period, and because the owner signs and distributes all paychecks, the risk of potential misstatements is low. \_\_\_\_\_

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\_\_\_\_\_  
\_\_\_\_\_

7. Often the most efficient method of applying SAS No. 39 is to not apply it at all. Describe the circumstances in which you would *not* apply SAS No. 39:

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

(Note: The information on pages 22-29 through 22-32 relate to question no. 5 on page 22-27.)

A producer of concrete burial vaults and manholes, Porous Precast Company, was started by its president and 100% shareholder, Harry Hiller, in 1965. Hiller began his career as a building contractor and land developer. When he started the Company, he owned 2,000 acres of development land, a construction company, a paving company, and a lumber yard. He is the original "fly-by-the-seat-of-your-pants" entrepreneur. Basically honest, he lacks sound business education and experience, and makes decisions impulsively. In spite of himself, his business ventures were in the right place at the right time. Although continually requiring additional funds to finance his expansion plans, Hiller's "vertical monopoly" of the companies return better than average profits. Hiller's personal style of living is, as you might expect, excessive. Living in an \$800,000 home, driving two new Mercedes and making frequent trips to luxurious international resorts, his personal cash requirements are gigantic!

The Company was initially financed by \$50,000 Hiller borrowed from another of his companies and a \$150,000 SBA loan he personally guaranteed. The Company is the only one of its kind in a 300-mile radius and is highly profitable. Requiring substantial working capital and fixed assets investments, however, the Company has continuing cash flow problems. It maintains a line of credit at the First Bank. The Company is operated and managed by the Loyale family. Their responsibilities include:

Ron Loyale — General Manager:

Ron Loyale is the primary reason for this Company's existence. Hiller makes major financial decisions but is not involved in the daily operations of the Company. Ron's endless energy is devoted to selling and producing the Company's products. He has sole customer contact and is responsible for supervising the 25 production employees. Ron is not involved with the daily accounting operations except for signing checks and reviewing supporting documents. He does, however, distribute weekly payroll checks. Ron and his crew take an annual, year-end physical inventory. His compensation is 50% of the annual pre-tax profits.

Sima Loyale (Daughter) — Receptionist and Clerk:

Sima takes customer's phone orders, makes daily bank deposits, prepares payroll and general checks, and types customer's monthly statements. There are no shipping or receiving reports in use. Sales are recorded based on sales tickets and cash disbursements are made based on vendor's invoices.

Carol Loyale (Wife) — Bookkeeper:

Carol posts the cash receipts journal, cash disbursements journal, and the accounts receivable subledger. She also reconciles the bank statements monthly. Occasionally, Carol also performs Sima's responsibilities. She is very methodical and exacting in her work.

The CPA firm has been providing monthly write-up services for the Company for the past three years. Posting the general ledger and compiling, without disclosures, a monthly balance sheet and earnings



statement for Hiller's review have been the CPA firm's primary functions. Hiller also reviews monthly the subledger and cash receipts and disbursements journals. The bookkeeping staff completes a compilation engagement work program for each monthly financial statement. The work program and financial statements are reviewed by a partner before issuance. Among other monthly compilation procedures, the bookkeeping staff makes working paper adjustments for accruals, checks bank reconciliations, reconciles the accounts receivable subledger, adjusts inventories by the gross profit method, and investigates large or unusual transactions.

**POROUS PRECAST PRODUCTS COMPANY**

**BALANCE SHEETS**

**December 31, 19X and 19W**

	<u>19X</u>	<u>19W</u>
<b>Current Assets:</b>		
Cash	\$ 17,600	\$ 31,900
Trade accounts receivable	176,200	141,900
Raw materials inventories	57,800	45,300
Finished goods inventories	129,600	111,400
Prepaid expenses	<u>1,400</u>	<u>1,100</u>
Total current assets	382,600	331,600
<b>Property, Plant and Equipment:</b>		
Land	47,000	47,000
Buildings and improvements	261,300	258,200
Machinery and equipment	330,200	204,400
Vehicles	<u>159,500</u>	<u>129,800</u>
	798,000	639,400
Less: accumulated depreciation	<u>(103,700)</u>	<u>(64,700)</u>
	694,300	574,700
Other assets	<u>28,000</u>	<u>28,000</u>
	<u>\$1,104,900</u>	<u>\$ 934,300</u>
<b>Current Liabilities:</b>		
Notes payable — First Bank	\$ 36,000	\$ 11,000
Accounts payable	42,900	20,500
Accrued expenses	5,800	1,700
Current portion — long-term debt	<u>38,000</u>	<u>23,000</u>
Total current liabilities	122,700	56,200
<b>Long-term Debt — First Bank</b>	435,000	375,000
— Rhoades Development Company	<u>23,000</u>	<u>23,000</u>
Total liabilities	<u>580,700</u>	<u>454,200</u>
<b>Stockholders' Equity:</b>		
Common stock	50,000	50,000
Retained earnings	<u>474,200</u>	<u>430,100</u>
	<u>524,200</u>	<u>480,100</u>
	<u>\$1,104,900</u>	<u>\$ 934,300</u>

**POROUS PRECAST PRODUCTS COMPANY**

**EARNINGS STATEMENTS**

**December 31, 19X and 19W**

	<u>19X</u>	<u>19W</u>
Sales:		
Caskets	\$ 460,100	\$ 430,200
Manholes	469,400	438,600
Other income	<u>500</u>	<u>1,200</u>
Total income	<u>930,000</u>	<u>870,000</u>
 Cost of Sales		
Labor	353,200	304,100
Materials	186,500	156,900
Salaries and wages	44,700	37,600
Depreciation	39,000	36,000
Insurance	13,000	12,000
Gas and oil	21,300	19,600
Payroll taxes	42,100	39,400
Repairs and maintenance	7,000	5,000
Travel expenses	2,500	1,500
Telephone	3,600	3,000
Office supplies and expenses	5,700	4,500
Manufacturing supplies and expenses	39,600	41,400
Professional services	9,300	8,700
Uncollectable accounts	2,100	5,400
Dues and subscriptions	800	700
Taxes and licenses	3,200	2,900
Advertising	5,100	3,600
Other	1,100	900
Interest	<u>82,100</u>	<u>73,300</u>
	<u>861,900</u>	<u>756,500</u>
 Earnings before income taxes	68,100	113,500
 Income taxes	<u>24,000</u>	<u>56,000</u>
 Net earnings	44,100	57,500
 Retained earnings, beginning of the year	<u>430,100</u>	<u>372,600</u>
 Retained earnings, end of year	<u>\$ 474,200</u>	<u>\$ 430,100</u>



W/P Ref.: T3-1

Client: ABC Company, Inc.  
**WORKING TRIAL BALANCE**  
 As of December 31, 1993

Prepared by: SHD  
 Reviewed by:

Date: 01-Mar.-94  
 Date:

W/P Ref.	A/C	Description	Per Ledger	Adjustments		Adjusted Balance	Reclassifications		Final
				Dr.	Cr.		Dr.	Cr.	
A-1	1000	Cash	2,696			2,696			2,696
B-1	1150	Trade Accounts Receivable	98,688	271	886	98,073			98,073
B-2	1175	Other Accounts Receivable	11,066			11,066			11,066
B-2	1195	Income Tax Receivable	0			0			0
C-1	1200	Inventory	84,446			84,446			84,446
E-1	1250	Prepaid Expenses	261			261			261
B-3	1310	Notes Receivable — Current	0			0	2,400		2,400
B-1	1100	Fixed Assets	37,397			37,397			37,397
B-1	1310	Accumulated Depreciation	(21,697)			(21,697)			(21,697)
B-3	1320	Notes Receivable	7,340			7,340	0	2,400	4,940
E-1	1400	Other Assets	1,164			1,164			1,164
G-1	2000	Accounts Payable	(87,349)	0	859	(88,208)			(88,208)
G-2	2210	Accrued Payroll Taxes	(226)			(226)			(226)
G-3	2220	Other Accrued Expenses	1,939	0	3,000	(1,061)			(1,061)
K-1	2294	Income Taxes Payable	952	0	5,066	(4,114)			(4,114)
M-1	2310	Long-Term Debt — Current	0			0	0	18,509	(18,509)
M-1	2320	Long-Term Debt	(40,308)			(40,308)	18,509	0	(21,799)
K-1	2295	Deferred Income Taxes	(5,800)		3,534	(9,334)			(9,334)
N-1	2800	Capital Stock	(9,000)			(9,000)			(9,000)
N-1	2900	Retained Earnings	(81,569)	13,345	271	(68,495)	1,000	1,000	(68,495)

(Continued)

W/P Ref.: T3-1

Client: ABC Company, Inc.  
 WORKING TRIAL BALANCE  
 As of December 31, 1993  
 (Continued)

Prepared by: SHD  
 Reviewed by:

Date: 01-Mar.-94  
 Date:

W/P Ref.	A/C	Description	Per Ledger	Adjustments		Adjusted Balance	Reclassifications		Final
				Dr.	Cr.		Dr.	Cr.	
3000		Net Sales	837,076			837,076			837,076
3500		Other	42,592			42,592			42,592
4100		Cost of Sales	(619,265)			(619,265)			(619,265)
4200		Selling Expenses	(14,058)			(14,058)			(14,058)
4300		Operating Expenses	(52,210)	859		(53,069)			(53,069)
4400		General and Administrative Expenses	(36,934)			(36,934)			(36,934)
4450		Payroll and Fringe Expenses	(119,231)	3,000		(122,231)		1,000	(121,231)
5110		Amortization and Depreciation	(7,053)			(7,053)			(7,053)
5120		Bad Debt Expense	235			(380)			(380)
5130		Interest Expense	(9,409)		271	(9,409)			(9,409)
6100		State Taxes		556		(556)			(556)
6210		Federal Taxes		4,510		(4,510)			(4,510)
6220		Deferred Income Taxes		3,535		(3,535)			(3,535)
		Net Income	<u>21,743</u>			<u>8,668</u>			<u>8,668</u>

Client: ABC Company, Inc.  
**SUMMARY OF POSSIBLE JOURNAL ENTRIES**  
 Financial Statement Date: December 31, 1995

Overall materiality limit: \$23,000  
 Amount over which misstatements should be posted to this form: \$ 1,000

W/P Ref.	Journal Entry Debit (Credit)	BALANCE SHEET			INCOME STATEMENT			
		Current Assets	Noncurrent Assets	Current Liabilities	Equity	Known Misstatements	Projected Misstatements	TOTAL*
C-1	Inventory	1,000						
C-1	Income Taxes Payable			(460)		(540)		(540)
C-1	G & E Expenses To reclassify materials purchased							
G-1	Fixed Assets		3,790					
G-1	Accounts Payable — Office To record unrecorded liability			(3,790)				
I-1	Accounts Receivable	3,500						
I-1	Sales				(1,512)			1,300
I-1	Income Taxes Payable To record unrecorded liabilities derived from nonstatistical sample			(1,288)				1,300
I-2	Operating Expenses							
I-2	Income Taxes Payable			9,879				1,006
I-2	Accounts Payable — Factory To record unrecorded liabilities derived from nonstatistical sample			(10,885)				
I-2	Net Sales							
I-2	Income Taxes Payable			3,275				5,040
I-2	Accounts Receivable To adjust for overstatement of receivables derived from nonstatistical sample	1,765						
Total Unrecorded Misstatements		6,265	3,790	(3,269)	(1,512)	(540)	7,346	6,806*
Corresponding Financial Statement Amounts		198,942	21,804	(112,118)	(77,495)			2,314
Percentage of Total Unrecorded Misstatements to Corresponding Financial Statement Amounts		3%	17%	3%	2%			<u>8,668</u>
								<u>52%</u>

\* Total of known, estimated and projected misstatements columns.

\*\* Apply the client's effective tax rate to the total unrecorded misstatements (income statement). Subtract the tax amount from the total unrecorded misstatement amount for the tax effected amount.

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**SUGGESTED ANSWERS TO REVIEW QUESTIONS**

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## 1. a. Overall engagement risk:

- (1) Integrity of management — evaluated as part of the annual client acceptance and retention decision. Acceptance of client indicates that the integrity of management is considered adequate.
- (2) Use of financial statements — risk usually is high because auditors cannot control the ultimate distribution and use of the financial statements, i.e., in legal proceedings, to obtain credit, etc.
- (3) Auditability of the entity — determined from discussions with management and the predecessor auditor. If the accounting system does not provide sufficient evidence to support the recorded transactions, the entity may be unauditible.
- (4) Business environment — Is the client in a financial position where bankruptcy, takeover or merger, could occur?

Overall engagement risk affects the level of evidence for *all* financial statement classifications.

## b. Risks of potential misstatements:

- (1) Inherent risks — risk of misstatement resulting from the nature of the transaction or balance.
- (2) Control risks — risk of misstatement resulting from weaknesses in the internal control structure.
- (3) Detection risks — the likelihood that audit procedures will lead the auditor to conclude that misstatement exceeding tolerable misstatement does not exist, when in fact, it does exist.

Risks of potential misstatements affect the evidence requirement for *specific* financial statement classifications.

2. Overall materiality limit, or planning materiality, is the maximum amount of misstatements, known and unknown, that's acceptable in the financial statements taken as whole without adjustment. Because misstatements are likely to first become material to earnings, the overall materiality limit is normally first applied to earnings before taxes. A limit may also be assigned to major financial statement item for considering effects of the potential journal entries on individual classifications.

Tolerable misstatement amount is the maximum amount of misstatements, known and unknown, that's acceptable in a general ledger account balance without adjustment. Tolerable misstatement results from the allocation of the overall materiality limit to major general ledger account balances. Tolerable misstatement determination is generally only necessary for classical variables sampling applications. A basic allowance for undetected misstatement can be used in place of tolerable misstatement amount for nonstatistical sampling applications supported by PPS theory.

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**SUGGESTED ANSWERS TO REVIEW QUESTIONS (Continued)**

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3. a. Using materiality guidelines on page 22-7, the overall limit is about \$23,000
- b. The total earnings effect of the misstatements does not exceed the overall materiality limit. The results of the procedures appear sufficient and more work should be unnecessary. When total misstatements exceeds 40% to 50% of the overall materiality limit, some corrective action should be considered. If amounts of misstatement would come close to this limit, the auditor should at least review the composition of unadjusted and projected misstatements for any major *causes* that should be investigated. Investigating causes may enable the auditor to quantify additional *actual* misstatement.
- c. First, the auditor should examine the projected misstatements, their causes and the conditions they may represent. Price test misstatements resulting from a client employee using prior year prices instead of current vendor invoices, for example, would require a repricing of the work done by the employee. Actual misstatement could be determined, adjusted, and removed from the projected misstatement. It may also be necessary to make other adjustments of actual misstatement. If misstatement amounts are still unacceptable, the auditor may need to further expand tests in the areas of misstatement.
- d. The auditor should usually consider corrective action when total misstatement exceeds 50% of the overall materiality limit because of the sampling risk. Sampling risk is the risk the total population will contain more misstatement than detected in the sample. Sampling risk is higher when using nonstatistical sampling than it is when using statistical sampling.
- e. A primary purpose is to facilitate effective misstatement analysis. Considering the causes of misstatements and their effects on the financial statements as a whole is a basic element of an effective audit. Using the Summary of Possible Journal Entries Form helps staff avoid wasting time investigating every small actual or projected misstatement and centralizes control over the additional procedures considered necessary.
- A secondary purpose of the overall materiality limit is to provide a subjective guideline for making judgments about immaterial accounts and audit areas. Deciding in advance not to prepare working papers for immaterial accounts, for example, can save considerable time.
4. The key factors are the assessment of overall engagement risk and the risk of potential misstatements. The Planning Matrix illustrates the correlation of these factors for the ABC System approach.

Past experience with the client, of course, will also be a factor in deciding the most cost-beneficial approach. An assessment of control risk at the maximum or financial statement classifications that can be most efficiently audited by tests of balances procedures, might be reasons for placing high reliance on tests of balances and restricting or eliminating tests of controls.

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**SUGGESTED ANSWERS TO REVIEW QUESTIONS (Continued)**

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5. a. At first glance, most will select high reliance on tests of balances with the System C approach or the All-Substantive Approach. They will assess control risk at the maximum because of family relationships of employees and the lack of internal controls. However, the ongoing involvement of the CPA firm and the owner compensates somewhat for the lack of internal controls. If it were not for the family problem, a System B approach might be appropriate. Before making such a decision, however, the auditor needs to consider the nature and composition of the general ledger account balances and overall engagement risk to determine if a tests of balances approach would be most cost-beneficial.
- b. Despite the lack of segregation of duties and the fact that the business is run by the family, the owner's review of some records and financial statements should produce reliable financial records. Unless experience with the client or some other concrete facts showed otherwise, or unless it was more cost beneficial to perform tests of balances, consider performing System B tests of controls on some transaction cycles.
6. a. The high risk of misstatement in cutoff can be mitigated by expanding the year-end sales cutoff tests to cover the period the clerk is on vacation. In addition to careful tests of cutoff, some additional pricing and mathematical accuracy tests may be appropriate for larger sales transactions.
- With extended tests of balances planned for the cutoff problem, and with low overall engagement risk, this would be a classic System A audit. Plan high reliance on tests of controls and analytical procedures and low reliance on tests of balances.
- b. With no significant risks of potential misstatements, plan low reliance on tests of balances. The high overall engagement risk may, however, cause both tests of controls and tests of balances sample sizes to be slightly larger than normal. A System B test of controls test is indicated for this cycle unless, of course, high reliance on tests of balances is more efficient.
- c. This is a classic opportunity for performing a predictive analytical procedure. A quantity reconciliation, multiplying hours worked by pay rates for the period of time each employee was employed, would substantially verify all financial statement assertions for payroll. The auditor would, of course, have to test the reliability of the records from which such data is obtained. In such a case, other tests of controls or balances probably would not be necessary.
7. If the sampling population is clearly immaterial, SAS No. 39 may need not be applied and the auditor can make the decision *not* to sample. For some smaller engagements, avoiding the sampling application may be another opportunity to save time. The judgments affecting such decisions not to sample, however, must be documented in the working papers. A Sampling Decisions Working Paper is illustrated in section 10.504.

**CPE EXAM**

This examination consists of 20 True (T) or False (F) statements. Please indicate the correct answer by blackening in the appropriate space on your self-study examination answer sheet.

Please note that answers are based solely on the information contained in the course materials and in the Manual. The correctness of an answer is judged on the content alone and does not necessarily reflect the opinion of the AICPA.

1. The basic components of overall engagement risk are:
  - The integrity of the client's management
  - The intended use of the financial statements
  - Auditability of the entity
  - Control risk
2. A small closely-held company would be a factor causing high risk regarding use of financial statements.
3. The components of audit risk are inherent risk, control risk, and detection risk.
4. The preliminary estimate of materiality is the maximum amount by which the auditor believes the statements could be misstated, by known or unknown misstatements, and still not affect the decisions of reasonable users.
5. The overall materiality limit is the maximum amount the auditor believes the financial statements could be misstated, by known or unknown misstatements, and still not affect the decisions of reasonable users.
6. The internal control system consists of:
  - Control environment
  - Control procedures
  - Control risk
7. SAS No. 55 does not require the auditor to document the understanding of the internal control structure if the auditor is not going to perform tests of controls.
8. Under the All-Substantive Approach, control risk for most financial statement assertions is assessed at slightly below the maximum to the maximum.
9. SAS No. 56 requires the auditor to apply analytical procedures during the planning and the completing of an engagement.



10. Substantive tests of balances normally make the most substantial contribution to financial statement assertions.
11. Completeness is a financial statement assertion outlined in SAS No. 31.

#### CPE EXAM (Continued)

12. SAS No. 39 defines audit sampling as the application of an audit procedure to more than 50% of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of the balance or class.
13. For nonstatistical sampling, the AICPA's Audit Sampling Guide indicates random-number sampling systematic sampling with or without random starts and haphazard sampling as possible methods for obtaining a representative sample.
14. Selecting individually significant items is part of the sampling application.
15. For nonstatistical sampling in tests of balances, there are three alternative approaches for selecting sample sizes. They are:

Judgmental approach

Table approach

Model approach

16. The model approach from the Audit Sampling Guide looks like this:

$$\frac{\text{Sampling Population}}{\text{Basic Allowance for Undetected Error}} \times \text{Sample Size} = \text{Assurance Factor}$$

17. The All-Substantive Approach Questionnaire uses a System B Test of Controls approach.
18. The Planning Matrix Form should be completed after the following documents have been finalized:

Client Acceptance and Continuance Form

Audit Planning Memorandum

Internal Controls Questionnaire

Risk of Potential Misstatements Evaluation Form

19. SAS No. 39 does not permit sample sizes to be determined judgmentally.
20. Tolerable misstatement is the maximum amount of misstatement, known and unknown, that can exist in the financial statement classifications without causing them to be materially misstated.





INDEX

References are to section numbers.

<b>ABC SYSTEM</b> . . . . .	3.101-3.107, 3.300-3.352	<b>AFFILIATED ENTITIES</b> (see also <b>BUSINESS COMBINATIONS; CONSOLIDATED AND COMBINED PRESENTATIONS</b> ) . . . . .	17.100
Accounting System . . . . .	3.103	<b>AICPA</b> (see <b>PROFESSIONAL PRONOUNCEMENTS AND STANDARDS</b> )	
Documentation . . . . .	3.405	<b>AICPA ACCOUNTING TRENDS AND TECHNIQUES</b> . . . . .	18.101-18.102
Evidence Matrix . . . . .	3.208	<b>AICPA AUDIT GUIDES</b> (see <b>PROFESSIONAL PRONOUNCEMENTS AND STANDARDS</b> )	
Internal Control Questionnaire . . . . .	3.103-3.104, 10.100	<b>AICPA NATIONAL AUTOMATED ACCOUNTING RESEARCH SYSTEM (NAARS)</b> . . . . .	18.101
Internal Control Structure . . . . .	3.303	<b>ADVERSE OPINION</b> . . . . .	19.102-19.103, 19.119
Overview . . . . .	3.100	<b>ALLOWANCE FOR DOUBTFUL ACCOUNTS</b> . . . . .	17.521
Planning Matrix . . . . .	3.348-3.352, 10.103	<b>ALL-SUBSTANTIVE APPROACH</b> . . . . .	3.105, 3.108, 3.400
Potential Misstatements Evaluation . . . . .	2.308	Analytical Procedures . . . . .	3.108, 3.205, 3.410
Primary Controls . . . . .	3.103	Characteristics of . . . . .	3.108
Relationship of Control Risk to Degree of Reliance on Controls . . . . .	3.105	Evidence Matrix . . . . .	3.208
Reliance Matrix . . . . .	3.105	Elective Use of Approach . . . . .	3.110
Risk Evaluation . . . . .	2.105	Forced Use of Approach . . . . .	3.113
Secondary Controls . . . . .	3.106	Impact on Tests of Balances . . . . .	3.207
Substantive Tests . . . . .	3.105	Internal Control Structure . . . . .	3.406-3.408
System Classifications . . . . .	3.103-3.104	Overview . . . . .	3.108
System A . . . . .	3.103-3.104, 3.307	Questionnaire . . . . .	10.203
System B . . . . .	3.103-3.104, 3.307	Use of Questionnaire . . . . .	3.112, 3.406-3.408
System C . . . . .	3.103-3.104, 3.112, 3.307	Reliance Matrix . . . . .	3.105
Tests of Balances . . . . .	3.106, 10.700	Substantive Tests . . . . .	3.108, 3.204-3.213
Tests of Controls . . . . .	3.106, 10.400	Tests of Balances . . . . .	3.108, 3.207, 3.411
		Tests of Controls . . . . .	3.202, 3.409
<b>ACCOUNTANTS' REPORTS ON COMPILED OR REVIEWED FINANCIAL STATEMENTS</b> (see <b>COMPILATION AND REVIEW REPORTS</b> )		<b>ALTMAN Z SCORE FORM</b> . . . . .	2.122-2.126, 10.304
<b>ACCOUNTING CHANGES</b> . . . . .	17.300, 19.113	<b>ANALYTICAL PROCEDURES</b>	
Business Combinations . . . . .	17.114	Audit Engagements . . . . .	2.341
Changes in Accounting Estimates . . . . .	17.311	Review Engagement . . . . .	4.600
Changes in Accounting Principles . . . . .	19.113	Substantive Test . . . . .	3.210
Changes in Reporting Entities . . . . .	17.310	<b>ANALYTICAL PROCEDURES PROGRAM</b>	
Consistency Matters . . . . .	19.113	Review Engagements . . . . .	4.600
Disclosures . . . . .	17.305	<b>APB OPINIONS</b>	
Restatement of Prior Period . . . . .	17.306	Opinion No. 16 . . . . .	17.112
<b>ACCOUNTING ESTIMATES</b>		Opinion No. 17 . . . . .	17.108
Auditing Estimates . . . . .	5.300	Opinion No. 18 . . . . .	17.103
Evaluating Reasonableness . . . . .	5.304	<b>APPROACH TO DRAFTING FINANCIAL STATEMENTS</b> . . . . .	16.000
<b>ACCOUNTING PRINCIPLES BOARD OPINIONS</b> (see <b>APB OPINIONS</b> )		<b>APPROACH TO REPORT PROCESSING AND REVIEW</b> . . . . .	16.400
<b>ACCOUNTING SYSTEM</b>		<b>APPROACH TO REPORT WRITING</b> . . . . .	16.300
Consideration of . . . . .	3.303	Reporting Limitations and Problems . . . . .	16.301
Elements . . . . .	3.303	<b>APPROACH TO WRITING NOTES</b> . . . . .	16.200
<b>ACCOUNTS PAYABLE</b> . . . . .	17.574	<b>ASSETS</b>	
<b>ACCOUNTS PAYABLE CONFIRMATION</b> . . . . .	13.015	Confirmation . . . . .	13.002-13.012
<b>ACCOUNTS RECEIVABLE</b> . . . . .	17.516, 17.518	<b>ASSOCIATION WITH FINANCIAL STATEMENTS</b> . . . . .	19.002-19.003, 20.100
Allowance for Doubtful Accounts . . . . .	17.521		
Installment Accounting Method . . . . .	17.519		
Receivables Financing . . . . .	17.520		
<b>ACCOUNTS RECEIVABLE-NEGATIVE CONFIRMATION REQUEST</b> . . . . .	13.006		
<b>ACCOUNTS RECEIVABLE-POSITIVE CONFIRMATION REQUEST</b> . . . . .	13.005		
<b>ACCRUED EXPENSES</b> . . . . .	17.575		

<b>AUDIT AREAS</b>		
Relationship to Transaction Cycles (Chart) . . . . .	3.306	
<b>AUDIT COMMITTEES</b>		
Communication of Reportable Conditions . . . . .	7.601, 7.606-7.613	
Communication of Certain Matters . . . . .	7.601-7.602, 7.618-7.619	
<b>AUDIT ENGAGEMENTS (see ABC SYSTEM; AUDIT PLANNING; AUDIT PROCESS; AUDITORS' REPORTS; FIRST-YEAR ENGAGEMENTS; SMALL, NONCOMPLEX ENGAGEMENT APPROACH)</b>		
<b>AUDIT GUIDES (see PROFESSIONAL PRONOUNCEMENTS AND STANDARDS)</b>		
<b>AUDIT PLANNING</b> . . . . .	2.300	
Analytical Procedures . . . . .	2.341	
Audit Approach . . . . .	3.100	
ABC System . . . . .	3.101, 3.300	
All-Substantive Engagement . . . . .	3.108-3.115, 3.400	
Audit Planning Decisions . . . . .	6.206	
Audit Planning Memorandum . . . . .	2.402, 10.300	
Deciding on Most Cost-Beneficial Audit Approach . . . . .	2.337, 6.206	
Designing the Audit . . . . .	2.315	
Documenting Planning Decisions . . . . .	2.400	
EDP Systems . . . . .	3.313	
Engagement Risk . . . . .	6.206	
Errors and Irregularities . . . . .	6.206	
Evaluating Audit Test Results . . . . .	2.316	
Evaluating Risk of Misstatements . . . . .	2.308, 6.206	
Illegal Acts . . . . .	6.206, 2.321	
Internal Control Structure, Obtaining Understanding of . . . . .	2.306, 6.206, 6.208	
Irregularities, Effect on Audit Report . . . . .	2.319, 6.206	
Materiality Judgment . . . . .	2.326	
Materiality Table . . . . .	2.329	
Memorandum (Documentation) . . . . .	10.300	
Misstatements (see <b>ERRORS, IRREGULARITIES,     AND ILLEGAL ACTS</b> )		
Overall Engagement Risk . . . . .	6.206	
Plan for Supervision . . . . .	2.333, 6.206	
Planning Matrix . . . . .	3.348	
Sampling (see <b>SAMPLING</b> ) . . . . .	3.500	
Staffing and Supervision . . . . .	6.206, 6.207	
Time Control . . . . .	11.100	
<b>AUDIT PLANNING MEMORANDUM</b> . . . . .	10.300	
<b>AUDIT PROCESS</b>		
Summary — Flowchart . . . . .	1.301	
<b>AUDIT PROGRAM GENERATOR (APG)</b> . . . . .	1.804	
<b>AUDIT REPORTING SUMMARY</b> . . . . .	19.102	
<b>AUDIT RISK</b> . . . . .	6.206	
Confirmations, Impact on . . . . .	5.202	
<b>AUDIT SAMPLING (see <b>SAMPLING</b>)</b>		
<b>AUDIT SAMPLING EVALUATION FORM</b> . . . . .	10.504	
<b>AUDITING STANDARDS (see <b>STATEMENTS ON AUDITING STANDARDS</b>)</b>		
<b>AUDITORS' REPORTS</b>		
Adverse Opinion . . . . .	19.102, 19.607	
Audit Reporting Summary . . . . .	19.103	
Association With Financial Statements . . . . .	19.002-19.003	
Checklist . . . . .	18.300	
Comparative Financial Statements . . . . .	19.103, 19.300	
Audited and Unaudited Comparative . . . . .	19.303	
Predecessor Performed Prior-Period . . . . .	19.301	
Sample Reports . . . . .	19.602, 19.615-19.619	
Concepts of Reporting . . . . .	19.000	
Consistency Exceptions . . . . .	19.113	
Departures From GAAP . . . . .	19.103, 19.106, 19.606-19.607	
Disclaimer of Opinion . . . . .	19.102-19.103, 19.118, 19.604	
Disclosure Checklist . . . . .	18.300	
Errors, Irregularities, and Illegal Acts . . . . .	19.103, 19.110	
Emphasis of a Matter . . . . .	19.103, 19.505	
Sample Report . . . . .	19.628	
Explanatory Language . . . . .	19.103, 19.609	
First-Year Audits . . . . .	19.103, 19.105, 19.605	
Going-Concern Problems . . . . .	19.103, 19.124, 19.613	
Inadequate Disclosure . . . . .	19.103, 19.109, 19.608	
Independence . . . . .	19.103, 19.504, 19.627	
Modifications to Standard Report . . . . .	19.102-19.103	
Adverse Opinion . . . . .	19.102-19.103, 19.120, 19.607	
Departures From GAAP . . . . .	19.103, 19.106, 19.606-19.607	
Disclaimer of Opinion . . . . .	19.102-19.103, 19.118, 19.604	
Explanatory Language . . . . .	19.103, 19.609	
Inadequate Disclosure . . . . .	19.103, 19.109, 19.608	
Unacceptable Principles . . . . .	19.103, 19.106, 19.606-19.607, 19.610	
Errors, Irregularities, and Illegal Acts . . . . .	19.103, 19.110	
Failure to Apply Pronouncement . . . . .	19.103, 19.112, 19.611	
Modification Summary . . . . .	19.103	
Qualified Opinion . . . . .	19.102-19.103, 19.603, 19.608	
Scope Limitations . . . . .	19.102-19.104, 19.118	
Misstatements (see <b>ERRORS, IRREGULARITIES, AND ILLEGAL ACTS</b> )		
Qualified Opinion . . . . .	19.102-19.104, 19.106-19.112, 19.603, 19.606, 19.608	
Relying on Work of a Specialist . . . . .	19.502, 19.902-19.903	
Report Preparation		
Addressee . . . . .	19.004	
Letterhead . . . . .	19.004	
Level of Service . . . . .	19.004	
Report Dating . . . . .	19.004	
Report Signing . . . . .	19.004	
Salutation . . . . .	19.004	
Reissuance of Report as Predecessor . . . . .	19.510, 19.615-19.616	
Reissuance of Report Subsequent to Original Issue Date . . . . .	19.513	
Reports on Audited Financial Statements . . . . .	19.005	
Scope Limitations . . . . .	19.103-19.104, 19.118	
First-Year Audits . . . . .	19.105	
Sample Report . . . . .	19.603-19.604	
Single Financial Statement . . . . .	19.103, 19.501	
Sample Reports . . . . .	19.625-19.626	
Specialists, Relying on . . . . .	19.502	
Standard Report . . . . .	19.005	
Subsequent Discovery of Facts Existing at Report Date . . . . .	19.515	
Supplementary Information . . . . .	19.103, 19.400	
Common Interest Realty Associations (CIRA) . . . . .	19.403, 19.624	
Sample Reports . . . . .	19.620-19.624	
Updated Opinion Differs From Previous . . . . .	19.507	
Sample Report . . . . .	19.629	
Uncertainties . . . . .	19.103, 19.116, 19.612	
Departures From GAAP . . . . .	19.119	
Going-Concern Uncertainties . . . . .	19.124	
Resolution of the Uncertainty . . . . .	19.122	
When No Modification Is Required . . . . .	19.117	

<b>AUDITORS' REPORTS (cont.)</b>		<b>CLIENT REPRESENTATION LETTER (see REPRESENTATION LETTER)</b>	
Scope Limitations . . . . .	19.118	<b>COMBINED FINANCIAL STATEMENTS</b> . . . . .	17.100, 17.110
<b>Work of Other Auditors</b> . . . . .	19.200	<b>COMMITMENTS</b> . . . . .	17.592
No Reference to Other Auditor . . . . .	19.204	<b>COMMUNICATION REQUIREMENTS</b>	
Procedures . . . . .	19.205	Audit Committee or Equivalent . . . . .	13.034
Reference to Other Auditor . . . . .	19.203	Errors, Irregularities, and Illegal Acts . . . . .	7.614-7.617
Sample Report . . . . .	19.614	Internal Control Structure Related Matters . . . . .	7.606-7.613
<b>AUDITORS' REPORTS CHECKLIST</b> . . . . .	18.300	Material Weaknesses . . . . .	7.608
<b>AUDITORS' RESPONSIBILITIES</b>		Reportable Conditions . . . . .	7.606
Communications at Engagement Wrap-Up . . . . .	7.600, 7.701	Reportable Conditions Form . . . . .	10.801
Errors . . . . .	7.616	Reporting Requirements . . . . .	7.6103
Irregularities and Illegal Acts . . . . .	7.615	Sample Report on Reportable Conditions . . . . .	13.036, 13.037
Internal Control Related Matters . . . . .	7.606-7.613	Written or Oral . . . . .	7.604
Subsequent Discovery of Facts . . . . .	19.915-19.916	<b>COMMUNICATION WITH AUDIT COMMITTEE</b> . . . . .	13.034
<b>BALANCE SHEET</b> . . . . .	17.500, 18.102	<b>COMPARATIVE FINANCIAL STATEMENTS</b> . . . . .	19.700, 20.300, 20.310
<b>BANK BALANCE CONFIRMATION FORM</b> . . . . .	13.003	Audited and Unaudited Comparative . . . . .	19.300
<b>BANK CUTOFF STATEMENT</b> . . . . .	13.002	Discontinued Operations . . . . .	17.722
Confirmation Form . . . . .	13.002	Predecessor Performed Prior-Period . . . . .	19.301
<b>BANK RECONCILIATION WORKING PAPER</b> . . . . .	14.108	Sample Reports . . . . .	19.615-19.619, 20.931-20.932
<b>BANK TRANSFERS WORKING PAPER</b> . . . . .	14.109	<b>COMPARATIVE NOTES TO THE FINANCIAL STATEMENTS</b> . . . . .	17.003-17.004
<b>BUDGETS</b> . . . . .	11.001, 11.100	<b>COMPENSATED ABSENCES</b> . . . . .	17.576
Time Control Documents . . . . .	11.101-11.104	<b>COMPENSATING BALANCES</b> . . . . .	17.506
<b>BUSINESS COMBINATIONS</b>		<b>COMPILATION AND REVIEW ENGAGEMENTS</b>	
Changes in Method of Accounting . . . . .	17.114	Accountants' Reports — Compilations . . . . .	20.300
Contingent Consideration . . . . .	17.117-17.118	Accountants' Reports — Reviews . . . . .	20.400
Disclosure Illustrations . . . . .	17.119	Analytical Procedures . . . . .	4.600
Disclosures . . . . .	17.113	Analytical Procedures Checklist for Review Engagements . . . . .	10.905
Expenses . . . . .	17.113	Association With Financial Statements . . . . .	20.100
Pooling of Interests Accounting . . . . .	17.111, 17.113-17.119	Balance-Sheet Only . . . . .	20.600
Purchase Accounting . . . . .	17.112	Cash Basis Financial Statements . . . . .	4.703-4.704
Subsequent Events . . . . .	17.115-17.116	Checklist . . . . .	18.400
Supplemental Information . . . . .	17.113	Client Representation Letters . . . . .	4.400, 13.033
<b>CAPITALIZED INTEREST</b> . . . . .	17.563-15.566	Compilation Engagement Work Program . . . . .	10.903
<b>CASH AND CASH EQUIVALENTS</b> . . . . .	17.503	Contractual Agreements . . . . .	4.716-4.721
Compensating Balances . . . . .	17.506	Defined . . . . .	4.001, 4.101
Disclosure Illustration . . . . .	17.507	Documentation . . . . .	4.308, 4.900, 10.900
Overdrafts . . . . .	17.505	Different Levels of Service in Prior-Period . . . . .	20.500
Restricted Cash . . . . .	17.504	Disclosures . . . . .	4.707
<b>CASH BASIS FINANCIAL STATEMENTS</b> . . . . .	4.703, 20.803	Elements, Accounts, or Items of Financial Statements . . . . .	4.714-4.715
<b>CHECKLISTS</b>		Establishing Understanding With Client . . . . .	4.200
Auditors' Reports . . . . .	18.300	Flowchart Outlining the Requirements	
Financial Statements and Notes . . . . .	18.200	Compilation Engagement . . . . .	4.003
Reports on Compilations and Reviews . . . . .	18.400	Review Engagement . . . . .	4.104
Supervision and Review . . . . .	12.200-12.704	Form for Documenting Understanding of	
<b>CLIENT ACCEPTANCE AND CONTINUANCE</b>		Client's Business and Industry . . . . .	10.901
Auditability of Entity . . . . .	2.111	Supplement for Review Engagements . . . . .	10.902
Discussion . . . . .	2.100	Knowledge of Business and Industry . . . . .	4.300
Documentation Form . . . . .	10.000	Income Tax Basis Financial Statements . . . . .	4.702
Documentation Form, Use of . . . . .	2.131-2.133	Inquiries of Client Personnel . . . . .	4.500
Independence . . . . .	2.115	Levels of Service . . . . .	20.211-20.212, 20.500
Integrity of Management . . . . .	2.106	Limited to One Financial Statement . . . . .	20.600
Procedures for Evaluating . . . . .	2.103	Obtaining Additional or Revised Information . . . . .	4.005
Use of Financial Statements . . . . .	2.109	Other Comprehensive Bases of Accounting . . . . .	4.700, 4.708, 20.803
<b>CLIENT ACCEPTANCE AND CONTINUANCE FORM</b> . . . . .	10.000	Performing Compilations, Requirements . . . . .	4.002-4.006
		Performing Reviews, Requirements . . . . .	4.103-4.104
		Prescribed Forms . . . . .	4.708-4.713, 20.806
		Prior-Period Statements Compiled or Reviewed	
		by Other Accountants . . . . .	20.507
		Reading the Financial Statements . . . . .	4.006

<b>COMPILATION AND REVIEW ENGAGEMENTS (cont.)</b>	
Reports	20.900
Representation Letter	4.400
Sample Letter	13.033
Requirements for a Compilation	4.002-4.006
Requirements for a Review	4.103-4.104
Review Engagement Analytical Procedures Checklist	10.905
Review Engagement Work Program	4.504, 10.904
Sample Reports	20.900
Single-Financial Statement	20.600
Special Engagements	4.700, 20.800
SSARS Interpretations	4.717
SSARS No. 1	4.001-4.006, 4.101-4.104, 4.306, 4.701
SSARS No. 3	4.708-4.713
Statements on Standards for Accounting and Review Services (SSARS), Listing of	4.800
Statement of Cash Flows	4.706, 20.929
Uncertainties Affecting the Financial Statements Work Program	20.700-20.702
Compilation Engagements	10.903
Review Engagements	4.504, 10.904
<b>COMPILATION AND REVIEW REPORTS</b>	
Adverse Opinions	20.216
Association With Financial Statements	20.100
Comparative Compilation Reports	20.908-20.911
Compilation Report, Standard	20.902
Departures From GAAP	20.904-20.905
Different Levels of Service	20.211, 20.500
Higher Level in Current Period	20.506
Lower Level in Current Period	20.501-20.505
Sample Reports	20.909-20.910, 20.931-20.932
Elements, Accounts, or Items of Financial Statements	20.804
Sample Compilation Report	20.916
GAAP Departures	20.306-20.309, 20.927-20.928
Independence	20.215
Modifications to Standard Compilation Report	
Comparative — Disclosures Omitted	20.310
Departures From GAAP	20.306-20.309
Omission of Disclosures	20.304
Omission of Statement of Cash Flows	20.906
Modifications to Standard Review Report	
Departures From GAAP	20.404-20.406
Omission of Statement of Cash Flows	20.929
Other Comprehensive Bases of Accounting	20.803
Cash Basis	20.803
Income Tax Basis	20.803
Sample Reports	20.914-20.915
Omission of Disclosures	20.304, 20.310
Prescribed Forms	20.805
Sample Compilation Report	20.918
Prior Period Compiled by Other Accountants	20.507-20.509
Sample Report	20.911
Prior Period Reviewed by Other Accountants	20.507-20.509
Sample Report	20.933
Qualified Opinions	20.216
Reference to Report and Notes	20.214
Report Preparation	
Addressee	20.203
Dual-Dating	20.209-20.210
Letterhead	20.202
Level of Service	20.211-20.213
Report Dating	20.207
Report Signing	20.206
Salutation	20.205
Review Report, Standard	20.926
Single Financial Statement	20.600, 20.912, 20.034
Standard Compilation Report	20.902
Standard Review Report	20.926
Supplementary Information	
Sample Reports	20.913, 20.935-20.936
Uncertainties	20.700
Going-Concern Uncertainty	20.702-20.703
<b>COMPILATION ENGAGEMENT REVIEW PROGRAM</b> 10.903	
<b>COMPILATION REPORT, MODIFIED (see MODIFICATIONS TO STANDARD COMPILATION REPORT)</b>	
<b>COMPILATION REPORT, STANDARD (see COMPILATION AND REVIEW REPORTS)</b>	
<b>COMPLETING AN AUDIT ENGAGEMENT</b>	
Administrative Wrap-Up	7.700
Adjustments, Furnishing Clients With	7.704
Completing Reviews	7.702
Obtaining Signed Correspondence	7.703
Procedures	7.701
Review and "To Do" Lists	7.705
Scheduling Reviews	7.702
Tax Returns	7.706
Analytical Procedures	7.100
Overall Review Procedures	7.102-7.106
Communication Requirements	7.600
Audit Committee or Equivalent	7.601, 7.618
Internal Control Structure Related Matters	7.601
Errors, Irregularities, and Illegal Acts	7.601, 7.614-7.617
Material Weaknesses	7.601, 7.606-7.608
Reportable Conditions	7.601, 7.606-7.607, 10.841
Reporting Requirements	7.610
Sample Reports on Reportable Conditions	7.611, 13.036-13.037
Written or Oral	7.604
Consultations	7.002, 8.300
Objectives	8.304
Quality Control Standard	8.302
Requirements of	8.304
Sample Consultation Form	10.800
Situations Requiring Consultation	8.306
Control Form (or Financial Statement Control Form)	12.600, 12.604
Engagement Performance Review Checklist	12.411
Final Time Summarization	8.500
Legal Letters	7.002, 7.200
Immaterial Matters	7.206
Timing of Letter	7.207
Illustrative Letter	13.028, 13.029
Responses	7.207
Management Meeting Checklist	12.704
Performance Appraisals	8.400
Procedures	7.002
Representation Letter, From Client	7.002, 7.500
Dating	7.504
Content	7.502
Requirements	7.502
Sample Letter	13.032
Signature	7.503
Subsequent Events	7.002, 7.300, 12.300
Authoritative Literature	7.301
Documentation	7.303
Procedures	7.302
Subsequent Events Review Program	12.304
Summary of Possible Journal Entries	7.400
Supervision and Review	8.000
Executive Review	8.105
In-charge Review	8.104
Partner Review	8.106
Procedures	8.004
SAS No. 22	8.003
Working Paper Review	8.100

<b>COMPUTER PROCESSING (see EDP SYSTEMS)</b>	
<b>CONCEPTS OF REPORTING</b>	
<b>CONFIRMATIONS (see also CORRESPONDENCE LISTS AND FORMS)</b> . . . . .	5.200
<b>CONFIRMATION OF ACCOUNT BALANCE INFORMATION WITH FINANCIAL INSTITUTIONS</b> . . . . .	13.003
<b>CONFIRMATION OF CONTINGENT LIABILITIES</b> . . . . .	13.017
<b>CONFIRMATION OF LIFE INSURANCE POLICIES</b> . . . . .	13.011
<b>CONFIRMATION OF LINES OF CREDIT</b> . . . . .	13.016
<b>CONFIRMATION OF MONEY MARKET FUNDS</b> . . . . .	13.004
<b>CONFIRMATION PROCEDURES</b> . . . . .	5.200
Sample Forms and Letters . . . . .	13.003-13.012
<b>CONSISTENCY EXCEPTIONS</b> . . . . .	19.400
<b>CONSOLIDATED AND COMBINED PRESENTATIONS</b> . . . . .	17.100
<b>CONSULTATIONS</b> . . . . .	5.800, 8.300
Objectives . . . . .	8.304
Quality Control Standard . . . . .	8.302-8.304
Sample Consultation Form . . . . .	10.800
Situations Requiring Consultation . . . . .	8.306
With Specialists . . . . .	8.307
<b>CONSULTATION FORM</b> . . . . .	10.800
<b>CONSULTING SERVICES</b> . . . . .	21.000
<b>CONTINGENCIES</b> . . . . .	12.302
<b>CONTINGENT LIABILITIES CONFIRMATION</b> . . . . .	13.017
<b>CONTROL ENVIRONMENT (see INTERNAL CONTROL STRUCTURE)</b>	
<b>CONTROL FORM (see FINANCIAL STATEMENT CONTROL FORM)</b>	
<b>CONTROL PROCEDURES (see INTERNAL CONTROLS STRUCTURE)</b>	
<b>CONTROL RISK (see INTERNAL CONTROL STRUCTURE)</b>	
<b>CORRECTION OF AN ERROR IN PREVIOUSLY-ISSUED FINANCIAL STATEMENTS</b> . . . . .	17.312
<b>CORRESPONDENCE LIST AND FORMS (see also ENGAGEMENT LETTERS; LEGAL LETTERS; REPRESENTATION LETTERS)</b>	
Accounts Payable Confirmation . . . . .	13.015
Accounts Receivable—Negative Request . . . . .	13.006
Accounts Receivable—Positive Request . . . . .	13.005
Communication With Audit Committee . . . . .	13.034
Confirmation of Contingent Liabilities . . . . .	13.017
Confirmation of Lines of Credit . . . . .	13.016
Confirmation of Money Market Funds . . . . .	13.004
Correspondence Control . . . . .	14.102
Engagement Letter—Audit . . . . .	13.024
Engagement Letter—Compilation . . . . .	13.025
Engagement Letter—Review . . . . .	13.026
Inquiry Letter to Legal Counsel . . . . .	13.028
Inquiry Letter to Legal Counsel If Management Has Not Provided Details About Pending or Threatened Litigation . . . . .	13.029
Insurance In Force Confirmation Report . . . . .	13.038
Inventories Held by Warehouses or Others When Listing Is Provided by Client . . . . .	13.008
Listing Is Not Provided by Client . . . . .	13.009
Letter To Other Accountants Upon Whose Work We Plan To Rely . . . . .	13.022
Mortgage Debt Confirmation . . . . .	13.014
Notes Payable or Long-Term Debt Confirmation . . . . .	13.013
Notes Receivable Confirmation—Positive Request . . . . .	13.007
Pension Plan Actuarial Information . . . . .	13.030
Pension Plan Assets Held By Trustee . . . . .	13.031
Proposal Letter . . . . .	13.027
Registrar—Capital Stock . . . . .	13.018
Related Party Confirmation . . . . .	13.020
Reliance Letter . . . . .	13.035
Report on Reportable Conditions . . . . .	13.036
Report on Reportable Conditions That Also Identifies a Material Weakness . . . . .	13.037
Representation Letter—Audit Engagement . . . . .	13.032
Representation Letter—Review Engagement . . . . .	13.033
Representation Letter to Other Accountants . . . . .	13.023
Request for Bank Cutoff Statement . . . . .	13.002
Safe Deposit Box Access Confirmation . . . . .	13.012
Securities Held By Brokers . . . . .	13.010
Standard Confirmation Inquiry for Life Insurance Policies . . . . .	13.011
Standard Form To Confirm Account Balance Information With Financial Institutions . . . . .	13.003
Transfer Agent—Capital Stock . . . . .	13.019
Uniform Commercial Code Confirmation . . . . .	13.021
<b>COST METHOD</b>	
Financial Statements of Foreign Subsidiaries . . . . .	17.105
<b>CPE COURSE</b> . . . . .	Chapter 22
<b>CURRENT ASSETS (see ASSETS)</b>	
<b>CURRENT LIABILITIES (see LIABILITIES)</b>	
<b>DEBT (see LIABILITIES; LONG-TERM DEBT)</b>	
<b>DEBT AND EQUITY SECURITIES (see INVESTMENTS IN DEBT AND EQUITY SECURITIES; LOSSES ON INVESTMENTS IN DEBT AND EQUITY SECURITIES)</b>	
<b>DEFERRED COMPENSATION PLANS</b> . . . . .	5.401
<b>DEFERRED TAXES</b> . . . . .	17.708
<b>DEPARTURES FROM GAAP</b>	
Effect on Auditor's Report . . . . .	19.106
<b>DIFFERENT LEVELS OF SERVICE</b> . . . . .	20.500
Higher Level in Current Period . . . . .	20.506
Lower Level in Current Period . . . . .	20.501-20.505
Sample Reports . . . . .	20.909-20.910, 20.931-20.932
<b>DISCLOSURE CHECKLIST (see FINANCIAL STATEMENTS AND NOTES DISCLOSURE CHECKLIST)</b>	
<b>DISCLOSURES (see FINANCIAL STATEMENT FORMAT, DISCLOSURES, AND TERMINOLOGY)</b>	
<b>DISCONTINUED OPERATIONS</b>	
Earnings-per-Share Data . . . . .	17.737
Segment of a Business . . . . .	17.719-17.724
<b>DIVIDENDS PAYABLE</b> . . . . .	17.579
<b>DISCLOSURE CHECKLIST</b> . . . . .	18.200
<b>DOCUMENTATION</b>	
Audit Memoranda, Use of . . . . .	6.301
Audit Planning Decisions . . . . .	2.400
Audit Sampling . . . . .	10.500

<b>DOCUMENTATION (cont.)</b>	
Basic Requirements	6.000
Billing File	6.109
Client-Prepared Working Papers	6.004
Compilation and Review Engagements	10.900
Compliance With Professional Standards	6.201
Correspondence File	6.107
Current Engagement File, Contents of	6.103-6.104
Documentation Packages	6.401, 9.100
EDP Documentation	10.600
Internal Control Structure	3.304, 6.208
Planning and Supervision File, Contents of	6.002
Permanent File, Contents of	6.105
Small, Noncomplex Engagement Approach	3.405
Sufficient and Competent Evidential Matter	5.001, 6.209
Supervision and Review	12.001
Tax File, Contents of	6.106
Time Budget and Control File	6.108
Time Control Documents	11.100
Understanding Internal Control Structure	3.301
Working Papers	
Client-Prepared	6.004
Files, Contents of	6.100-6.109
Statement of Cash Flows	14.129
Working Paper Conclusions	6.303
Working Paper Schedules	6.005
<b>EARNINGS PER SHARE (EPS) DATA</b>	17.725-17.737
Complex Capital Structure	17.728
Discontinued Operations	17.737
Fully-Diluted EPS	17.732, 17.736-17.737
Primary EPS	17.732, 17.733, 17.737
Simple Capital Structure	17.727
<b>ELEMENTS, ACCOUNTS, AND ITEMS OF A FINANCIAL STATEMENT</b>	4.714
Sample Compilation Report	20.916
<b>EDP SYSTEMS</b>	
EDP Controls	3.313-3.332
EDP Documentation	10.600
General Computer Controls Questionnaire	10.602
Microcomputer Questionnaire	10.601
Service Auditor Report Evaluation Form	10.652
Service Organization Application Controls Questionnaire	10.6XX
Service-Center-Produced Records	3.333-3.343
<b>ELECTRONIC DATA PROCESSING (see EDP SYSTEMS)</b>	
<b>EMERGING ISSUES TASK FORCE (EITF)</b>	
Consensuses (with Listing)	1.504-1.506
<b>EMPHASIS OF A MATTER</b>	19.505-19.506
<b>EMPLOYEE BENEFIT PLANS (see PENSION PLANS; POSTRETIREMENT BENEFITS; POSTEMPLOYMENT BENEFITS)</b>	
<b>ENGAGEMENT LETTERS</b>	2.200
For Audits	13.024
For Compilations	13.025
For Reviews	13.026
To Minimize Liability	2.206
<b>ENGAGEMENT PERFORMANCE REVIEW</b>	
Checklist	12.409-12.411
Engagement Executive Review	12.407
Engagement Partner Review	12.408
In-charge Review	12.406
Review of Working Papers	12.403-12.405
<b>ENGAGEMENT PERFORMANCE REVIEW CHECKLIST</b>	12.411, 16.402
<b>ENGAGEMENT PLANNING (see AUDIT PLANNING; SUPERVISION AND REVIEW)</b>	
<b>EQUITY METHOD</b>	
Financial Statements of Unconsolidated Subsidiaries	17.104
<b>ERRORS, IRREGULARITIES, AND ILLEGAL ACTS</b>	2.309-2.314, 6.206, 7.404, 7.614-7.617, 19.110
<b>ESTIMATES (see ACCOUNTING ESTIMATES)</b>	
<b>EVIDENCE ACCUMULATION</b>	
Affected by Engagement Risk	5.202
Audit Planning	6.209
Confirmations	5.200
Accounts Receivable	5.207
Audit Risk	5.202
Designing the Request	5.203
Process	5.201
Procedures	5.200, 5.204
Sample Letters and Forms	13.002-13.021
SAS No. 67	5.201, 5.203-5.207
Uniform Commercial Code	5.208-5.209
Consultation, Requirements of Sample Form	10.800
Documentation	6.209, 6.300
Estimates	5.300
Evidence Matrix	3.208
Methods of Evidence Accumulation	5.000
Sufficient Evidence	6.209
Tests of Balances	3.207
Types of Evidence	5.100
Uniform Commercial Code	5.208-5.209
<b>EVIDENCE MATRIX</b>	3.208
<b>EXTRAORDINARY ITEMS</b>	17.706, 17.713-17.716
<b>FAIR VALUES OF FINANCIAL INSTRUMENTS</b>	17.514
<b>FASB</b>	
EITF	1.504-1.506
Interpretation No. 39	17.513
Statements on Standards (see STATEMENTS OF FINANCIAL ACCOUNTING STANDARDS)	
<b>FINANCIAL ACCOUNTING STANDARDS BOARD (see FASB)</b>	
<b>FINANCIAL INSTRUMENTS</b>	17.514
<b>FINANCIAL STATEMENT CONTROL</b>	
FORM	12.600, 12.604, 16.405
Signing the Report	12.603, 16.407
<b>FINANCIAL STATEMENT FORMAT, DISCLOSURES, AND TERMINOLOGY</b>	16.104, 16.106
Accounting Changes (with Sample Disclosures)	17.400
Changes in Accounting Estimates	17.311
Changes in Accounting Principles	17.114, 17.302-17.305
Changes in Reporting Entities	17.310
Sample Disclosures	17.305
Restatement of Prior Period	17.306-17.309
Accounts Payable	17.574
Accounts Receivable	17.516, 17.518
Allowance for Uncollectible Accounts	17.521
Installment Accounting Method	17.519
Receivables Financing	17.520
Accrued Expenses	17.575

**FINANCIAL STATEMENT FORMAT, DISCLOSURES,  
AND TERMINOLOGY (cont.)**

Assets and Liabilities  
 Current Assets . . . . . 17.501  
 Current Liabilities . . . . . 17.571  
 Balance Sheet . . . . . 17.500, 18.102-18.103  
 Business Combinations  
 Changes in Methods of Accounting . . . . . 17.114  
 Contingent Consideration . . . . . 17.117-17.118  
 Disclosure Illustrations . . . . . 17.119  
 Disclosures, Requirements for . . . . . 17.113  
 Expenses . . . . . 17.113  
 Pooling of Interests . . . . . 17.111  
 Purchases . . . . . 17.112  
 Subsequent Events . . . . . 17.115-17.116  
 Supplemental Information . . . . . 17.113  
 Capitalized Interest . . . . . 17.563-17.566  
 Cash and Cash Equivalents . . . . . 17.503  
 Compensating Balances . . . . . 17.506  
 Disclosure Illustration . . . . . 17.507  
 Overdrafts . . . . . 17.505  
 Restricted Cash . . . . . 17.504  
 Cash Overdrafts . . . . . 17.505  
 Combined Financial Statements . . . . . 17.110  
 Commitments . . . . . 17.592  
 Comparative Financial Statements . . . . . 17.722, 19.700  
 Comparative Notes . . . . . 17.003-17.004  
 Compensated Absences . . . . . 17.576  
 Compensating Balances . . . . . 17.506  
 Consolidated and Combined Presentations . . . . . 17.100  
 Contingencies . . . . . 17.588-17.590  
 Contra Accounts . . . . . 17.502  
 Correction of an Error in Previously-Issued  
 Financial Statements . . . . . 17.312  
 Cost Method . . . . . 17.105  
 Current Assets . . . . . 17.501  
 Current Liabilities . . . . . 17.571  
 Debt and Equity Securities, Investments  
 Disclosures . . . . . 17.508-17.512  
 Deferred Taxes . . . . . 17.708  
 Disclosure Principles . . . . . 17.007-17.009  
 Disclosures, Consolidations . . . . . 17.102  
 Discontinued Operations . . . . . 17.719-17.724  
 Dividends Payable . . . . . 17.579  
 Earnings-per-Share Data . . . . . 17.725-17.737  
 Earnings Statement . . . . . 17.700, 18.104-18.105  
 Equity Method . . . . . 17.104  
 Error Correction . . . . . 17.312  
 Errors and Irregularities . . . . . 2.309-2.314, 2.319-2.325  
 Estimated Liabilities . . . . . 17.580  
 Expenses, Accrued . . . . . 17.575  
 Extraordinary Items . . . . . 17.706, 17.713-17.716  
 Financial Instruments . . . . . 17.514  
 Goodwill . . . . . 17.108  
 Historical Summaries of Financial Information . . . . . 17.314  
 Imputed Interest . . . . . 17.587  
 Income Statement (see also STATEMENT OF EARNINGS;  
 EARNINGS STATEMENT) . . . . . 17.578  
 Income Taxes . . . . . 17.109, 17.708  
 Installment Accounting Method . . . . . 17.519  
 Intangible Assets . . . . . 17.567  
 Interest  
 Capitalized . . . . . 17.563-17.566  
 Imputed . . . . . 17.587  
 Inventories . . . . . 17.523  
 LIFO Inventories . . . . . 17.302, 17.527-17.529  
 Investments In and Advances To Affiliated Entities . . . . . 17.531-17.541  
 Investments in Debt and Equity Securities . . . . . 17.508-17.512

Leases — Lessees . . . . . 17.545-17.552  
 Capital Leases . . . . . 17.550-17.552  
 Operating Leases . . . . . 17.547-17.549  
 Disclosure Illustration . . . . . 17.562  
 Disclosures . . . . . 17.555  
 Leases — Lessors . . . . . 17.553-17.562  
 Sales-Type and Direct Financing Leases . . . . . 17.554  
 Leveraged Leases . . . . . 17.558-17.561  
 Liabilities, Long-Term . . . . . 17.582  
 Life Insurance Policy Loans . . . . . 17.581  
 Litigation . . . . . 17.591  
 Long-Term Debt . . . . . 17.582  
 Long-Term Liabilities . . . . . 17.582  
 Management Representations . . . . . 17.010  
 Materiality . . . . . 17.005  
 Minority Interests . . . . . 17.107  
 Misstatements (see ERRORS AND IRREGULARITIES; AND  
 ILLEGAL ACTS)  
 Name of Entity in Title . . . . . 17.001  
 Notes Receivable . . . . . 17.516, 17.518  
 Notes Payable . . . . . 17.572  
 Notes to the Financial Statements . . . . . 18.112  
 Offsetting Assets and Liabilities . . . . . 17.513  
 Other Assets . . . . . 17.568-17.570  
 Pooling of Interests Accounting . . . . . 17.113, 17.119  
 Prepaid Expenses . . . . . 17.530  
 Prior-Period Adjustments . . . . . 17.717-17.718  
 Property and Equipment . . . . . 17.542-17.544  
 Prospective Financial Statements . . . . . 20.103  
 Purchase Accounting . . . . . 17.113, 17.119  
 Receivables Financing . . . . . 17.520  
 Receivables From Officers, Directors, Shareholders,  
 Affiliated Entities, and Employees . . . . . 17.517  
 References to Applicable Pronouncements . . . . . 17.006  
 Referencing Notes . . . . . 17.002  
 Related Party Transactions . . . . . 17.200  
 Disclosures . . . . . 17.203-17.205  
 Disclosure of Major Customer . . . . . 17.206-17.207  
 Restricted Cash . . . . . 17.504  
 Retained Earnings, Statement of . . . . . 18.106  
 Retirement and Pension Plans . . . . . 17.593-17.596  
 Deferred Compensation Contracts . . . . . 17.596  
 Profit-Sharing Plans . . . . . 17.595  
 Segments of a Business Enterprise . . . . . 17.800  
 Shareholders' Equity . . . . . 17.600, 18.106-18.108  
 Additional Paid-In Capital . . . . . 17.604  
 Capital Stock . . . . . 17.603  
 Dividends . . . . . 17.607  
 Retained Earnings . . . . . 17.606, 18.106  
 Statement of . . . . . 18.106-18.108  
 Treasury Stock . . . . . 17.605  
 Statement of Cash Flows . . . . . 17.900, 18.109-18.111  
 Statement of Earnings . . . . . 17.700, 18.104-18.105  
 Costs of Sales . . . . . 17.704-17.705  
 Discontinued Operations . . . . . 17.719-17.724  
 Sales . . . . . 17.702-17.703  
 Earnings-per-Share (EPS) . . . . . 17.725-17.737  
 Complex Capital Structure . . . . . 17.728  
 Fully Diluted EPS . . . . . 17.732, 17.736-17.737  
 Primary EPS . . . . . 17.732-17.733, 17.737  
 Simple Capital Structure . . . . . 17.727  
 Extraordinary Items . . . . . 17.713-17.716  
 Income Taxes . . . . . 17.708  
 Losses on Debt and Equity Securities . . . . . 17.706  
 Operating Expenses . . . . . 17.707  
 Other Expenses . . . . . 17.711  
 Other Income . . . . . 17.710



<b>FINANCIAL STATEMENT FORMAT, DISCLOSURES, AND TERMINOLOGY (cont.)</b>		<b>INCOME STATEMENT (see also STATEMENT OF EARNINGS)</b>	17.700, 18.104
Prior-Period Adjustments	17.717-17.718	<b>INCOME TAX BASIS OF ACCOUNTING</b>	4.702, 4.705-4.707, 20.803
Research and Development Costs	17.712	<b>INCOME TAXES</b>	
Tax-Exempt Entities	17.709	Undistributed Earnings of Subsidiaries	17.109
Statement of Retained Earnings	18.106	<b>INDEPENDENCE</b>	2.127-2.131, 19.504
Statement of Shareholders' Equity	18.106	<b>INQUIRIES</b>	
Stock Option and Stock Purchase Plans	17.597	Review Engagements	4.103, 4.500
Illustrative Disclosure	17.597	Subsequent Events	12.302
Subsequent Events	17.400	Work Program	10.904
Title of Financial Statements	17.001	<b>INQUIRY LETTER TO LEGAL COUNSEL</b>	13.028
Unconditional Purchase Obligations	17.584	<b>INQUIRY LETTER TO LEGAL COUNSEL IF MANAGEMENT HAS NOT PROVIDED DETAILS ABOUT PENDING OR THREATENED LITIGATION</b>	13.029
Unconsolidated Subsidiaries	17.104-17.106	<b>INSTALLMENT METHOD OF ACCOUNTING</b>	17.519
Undistributed Earnings of Subsidiaries	17.109	<b>INSURANCE IN FORCE CONFIRMATION</b>	13.038
<b>FINANCIAL STATEMENTS (see also FINANCIAL STATEMENT FORMAT, DISCLOSURE, AND TERMINOLOGY)</b>		<b>INTANGIBLE ASSETS</b>	17.567
Completing the Financial Statements	16.109	<b>INTEREST</b>	
Financial Statements and Notes Checklist	16.106	Capitalized	17.563-17.566
Modifying the Financial Statements	16.107	Imputed	17.587
<b>FINANCIAL STATEMENTS AND NOTES CHECKLIST</b>	16.106, 18.200	<b>INTERIM FINANCIAL INFORMATION, REVIEW OF</b>	
<b>FIRST-YEAR ENGAGEMENTS</b>	2.500	Applicability	5.650
Audit Reports	19.105	Performance Requirements	5.653
Communicating With Predecessor	2.501	Reporting Requirements	5.654
Documentation	2.508, 10.303	SAS No. 71	5.650-5.656
First Engagement Procedures	2.515	Subsequent Events	12.302
Other Accountants' Work, Relying on	2.515	<b>INTERNAL CONTROLS QUESTIONNAIRE</b>	3.304-3.309, 10.100
Procedures	2.515	<b>INTERNAL CONTROL STRUCTURE</b>	
Proposal, Preparation of	2.509	Accounting System	3.303
<b>FIRST ENGAGEMENT PROCEDURES FORM</b>	10.303	Control Environment	3.303
<b>FLOWCHARTS</b>		Control Procedures	3.303
Audit Process	1.301	Control Risk	3.204
Compilation Engagement	1.602	EDP System	2.602
Review Engagement	1.602	Elements (Components)	3.303
<b>FORECASTS AND PROJECTIONS</b>	20.103	Material Weaknesses	7.608
<b>FORM FOR DOCUMENTING UNDERSTANDING OF CLIENT'S BUSINESS AND INDUSTRY</b>	10.901	No Reportable Conditions	7.610
— SUPPLEMENT FOR REVIEWS	10.902	Obtaining an Understanding of	2.306, 6.206
<b>GAAP DEPARTURES</b>		Professional Literature	3.204
Auditors' Reports	19.106	Questionnaire	3.304, 10.100
Compilation Reports	20.306-20.309	Reportable Conditions	7.606
Review Reports	20.404-20.407	Reportable Conditions Form	10.801
<b>GAAP HIERARCHY (see also PROFESSIONAL PRONOUNCEMENTS)</b>	1.500	Reportable Conditions Sample Report	13.036, 13.037
<b>GAAS (see STATEMENTS ON AUDITING STANDARDS)</b>		Reporting Requirements	5.910-5.912
<b>GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (see GAAP)</b>		Sampling (see SAMPLING)	
<b>GENERALLY ACCEPTED AUDITING STANDARDS (see GAAS)</b>		Tests of Controls Program	10.400
<b>GOING-CONCERN CONSIDERATIONS (see UNCERTAINTIES)</b>		Understanding of	2.306
<b>GOODWILL</b>	17.108	<b>INTERNAL CONTROL STRUCTURE REPORTABLE CONDITIONS FORM</b>	10.801
<b>ILLUSTRATIVE FINANCIAL STATEMENTS, NOTES, AND AUDITOR'S REPORT</b>	18.500	<b>INVENTORY</b>	17.523-17.529
<b>IMPUTED INTEREST</b>	17.587	LIFO Inventory	17.302, 17.527-17.529
		<b>INVENTORIES HELD BY WAREHOUSES OR OTHERS</b>	
		When Listing is Provided by Client	13.008

<b>INVENTORIES HELD BY WAREHOUSES OR OTHERS (cont.)</b>		<b>MODEL APPROACH</b>	
When Listing is Not Provided by Client . . . . .	13.009	Sample Size Selection . . . . .	3.528-3.535
<b>INVESTMENTS IN DEBT AND EQUITY</b>		Working Paper . . . . .	10.505
SECURITIES . . . . .	17.508-17.512, 17.706	<b>MODEL APPROACH WORKING PAPER</b> . . . . .	10.505
<b>JUDGMENTAL SAMPLE SIZE SELECTION</b>		<b>MODIFICATIONS TO STANDARD AUDIT REPORT</b> . . . . .	19.100
Tests of Balances . . . . .	3.525	<b>MODIFICATIONS TO STANDARD COMPILATION REPORT</b>	
<b>LAWYER'S LETTERS (see LEGAL LETTERS)</b>		Departures From GAAP . . . . .	20.306-20.309
<b>LEASES</b> . . . . .	17.545-17.562	Disclosures Omitted . . . . .	20.304
<b>LEVERAGED LEASES</b> . . . . .	17.558-17.561	Comparative Financial Statements . . . . .	20.310
<b>LETTER TO OTHER ACCOUNTANTS UPON WHOSE WORK WE PLAN TO RELY</b> . . . . .	13.022	Statement of Cash Flows Omitted . . . . .	20.906
<b>LEGAL LETTERS (also referred to as LAWYER'S LETTERS)</b> . . . . .	7.002, 7.200	<b>MODIFICATIONS TO STANDARD REVIEW REPORT</b>	
Illustrative Letters . . . . .	13.028, 13.029	Departures From GAAP . . . . .	20.404-20.407
Immaterial Matters . . . . .	7.206	Statement of Cash Flows Omitted . . . . .	20.929
Inquiries . . . . .	13.028, 13.029	<b>MONEY MARKET FUND CONFIRMATION</b> . . . . .	13.004
Legal Fees, Request for Unpaid and Unbilled . . . . .	7.208	<b>MORTGAGE DEBT</b>	
Responses . . . . .	7.207	Confirmation Form . . . . .	13.014
SAS No.12 . . . . .	7.205	<b>MODIFICATIONS TO STANDARD AUDITOR'S REPORT</b> . . . . .	19.102
Subsequent Events . . . . .	12.302	Departures From GAAP . . . . .	19.103, 19.106
Timing of Letter . . . . .	7.207	Inadequate Disclosure . . . . .	19.109
<b>LIABILITIES</b> . . . . .	17.582	Unacceptable Principles . . . . .	19.106
<b>LIFE INSURANCE POLICIES CONFIRMATION</b> . . . . .	13.011	Errors, Irregularities, and Illegal Acts . . . . .	19.110
<b>LIFO INVENTORIES</b> . . . . .	17.302, 17.527-17.529	Failure to Apply Pronouncement . . . . .	19.112
<b>LINES OF CREDIT CONFIRMATION</b> . . . . .	13.016	Modification Summary . . . . .	19.103
<b>LITIGATION (see LEGAL LETTERS)</b>		Scope Limitations . . . . .	19.104
<b>LONG-TERM DEBT (see LIABILITIES)</b>		<b>MORTGAGE DEBT CONFIRMATION</b> . . . . .	13.014
<b>LOSSES ON INVESTMENTS IN DEBT AND EQUITY SECURITIES</b> . . . . .	17.512, 17.706	<b>NONSTATISTICAL SAMPLING</b> . . . . .	3.506, 3.524
<b>LOTUS 1-2-3</b> . . . . .	1.802	<b>NONSTATISTICAL SAMPLE SIZE SELECTION MATRIX -- TESTS OF CONTROLS</b> . . . . .	10.500
<b>MANAGEMENT MEETING CHECKLIST</b> . . . . .	12.700, 12.704	<b>NOTES PAYABLE</b>	
<b>MANAGEMENT REPRESENTATIONS (see REPRESENTATION LETTER)</b>		Confirmation . . . . .	13.013
<b>MANAGEMENT'S REVIEW AND APPROVAL OF FINANCIAL STATEMENTS</b> . . . . .	16.102	Financial Statement Presentation . . . . .	17.572
<b>MATERIALITY</b>		Working Papers . . . . .	14.122
Audit Planning . . . . .	2.326	<b>NOTES PAYABLE OR LONG-TERM DEBT CONFIRMATION</b> . . . . .	13.013
Computation Form . . . . .	10.301	<b>NOTES RECEIVABLE</b>	
Overall Limit . . . . .	2.326-2.332	Confirmation . . . . .	13.007
Table . . . . .	2.329	Financial Statement Presentation . . . . .	17.516, 17.518
<b>MATERIALITY COMPUTATION FORM</b> . . . . .	10.301	Working Papers . . . . .	14.113
<b>MATERIAL WEAKNESSES (see REPORTABLE CONDITIONS)</b>		<b>NOTES RECEIVABLE CONFIRMATION -- POSITIVE REQUEST</b> . . . . .	13.007
<b>MINORITY INTERESTS</b> . . . . .	17.107	<b>NOTES TO FINANCIAL STATEMENTS</b> . . . . .	18.112
<b>MISSTATEMENTS (see ERRORS, IRREGULARITIES, AND ILLEGAL ACTS)</b>		Approach to Writing Notes . . . . .	16.200
		Disclosure Requirements . . . . .	16.207
		Effective Writing Techniques . . . . .	16.201
		Major Notes Categories . . . . .	16.204
		Outlining the Contents . . . . .	16.209
		Reading the Completed Notes . . . . .	16.211
		Referencing . . . . .	16.214
		Review by Engagement Executive and In-charge . . . . .	16.212
		Using Prior-Year or Illustrative Notes . . . . .	16.210
		<b>OFFSETTING ASSETS AND LIABILITIES</b> . . . . .	17.513

<b>OTHER AUDITORS (see WORK OF OTHER AUDITORS)</b>	
<b>OTHER COMPREHENSIVE BASES OF ACCOUNTING</b>	
Cash Basis . . . . .	4.703-4.707
Income Tax Basis . . . . .	4.702, 4.705-4.707
Sample Reports . . . . .	20.914-20.915, 20.937-20.938
<b>OPERATING LEASES</b>	
Disclosure . . . . .	17.562
Financial Statement Presentation . . . . .	17.547-17.549
<b>OTHER ACCOUNTANTS, LETTERS TO . . . . .</b>	13.022, 13.023
<b>PEER AND QUALITY REVIEWS . . . . .</b>	6.209
<b>PENSION ACCOUNTING (see PENSION PLANS)</b>	
<b>PENSION PLAN ACTUARIAL INFORMATION . . . . .</b>	13.030
<b>PENSION PLAN ASSETS HELD BY TRUSTEE . . . . .</b>	13.031
<b>PENSION PLANS . . . . .</b>	17.593
Audit Procedures . . . . .	5.400
Pension Accounting Working Paper . . . . .	14.128
Pension Costs . . . . .	5.400, 17.594
Reliance on Actuary . . . . .	5.403, 5.504
SFAS No. 87 . . . . .	5.401, 17.594
SFAS No. 88 . . . . .	5.401
Tests of Balances . . . . .	5.402
<b>PERFORMANCE APPRAISALS . . . . .</b>	8.400
<b>PLANNING (see AUDIT PLANNING; SUPERVISION AND REVIEW)</b>	
<b>PLANNING MATRIX . . . . .</b>	3.348-3.352
<b>PLANNING MEMORANDUM . . . . .</b>	10.300
<b>POOLING OF INTERESTS ACCOUNTING . . . . .</b>	17.111, 17.113-17.119
<b>POSTRETIREMENT BENEFITS OTHER THAN PENSIONS</b>	
Actuary's Confirmation Letter, Sample of . . . . .	13.030
Audit Procedures . . . . .	5.504
Reliance on Actuary . . . . .	5.504
SFAS No. 106 . . . . .	5.501-5.503
<b>POSTEMPLOYMENT BENEFITS</b>	
Accounting for . . . . .	5.600
SFAS No. 112 . . . . .	5.601
<b>POTENTIAL MISSTATEMENTS MATRIX . . . . .</b>	10.102
<b>PREPAID INSURANCE . . . . .</b>	17.530
<b>PRESCRIBED FORMS . . . . .</b>	20.805
Sample Compilation Report . . . . .	20.918
<b>PRIOR-PERIOD ADJUSTMENTS</b>	
Accounting . . . . .	17.717-17.718
<b>PROFESSIONAL CONDUCT (see PROFESSIONAL STANDARDS)</b>	
<b>PROFESSIONAL PRONOUNCEMENTS AND STANDARDS</b>	
AICPA Audit Guides . . . . .	3.204, 3.501, 15.204, 17.303, 20.103
Code of Professional Conduct (and Rules) . . . . .	1.403-1.406
EITF Consensuses . . . . .	1.504-1.506
GAAP Hierarchy . . . . .	1.500, 1.504
Generally Accepted Auditing Standards . . . . .	1.600
Quality Control Standards . . . . .	1.702, 8.001, 8.302, 8.304, 12.101
References to Authoritative Literature . . . . .	1.708
Statements on Auditing Standards (see p. I-13)	
Statements on Financial Accounting Standards (see p. I-13)	
Statements on Standards for Accounting and Review Services (SSARS) Listing . . . . .	4.800
Statements on Standards for Attestation Engagements . . . . .	20.103
<b>PROPERTY, PLANT, AND EQUIPMENT . . . . .</b>	17.542, 17.544
Working Paper for Additions . . . . .	14.119
Working Paper for Disposals . . . . .	14.120
<b>PROPOSAL LETTER . . . . .</b>	13.027
<b>PURCHASE ACCOUNTING . . . . .</b>	17.112
<b>QUALITY CONTROL STANDARDS . . . . .</b>	1.702, 8.001, 8.302, 8.304, 12.101, 12.401
<b>RANDOM SELECTION WITH RANDOM TABLE FORM . . . . .</b>	10.501
<b>RANDOM SELECTION WITH SYSTEMATIC SAMPLE FORM . . . . .</b>	10.507
<b>RAW MATERIALS PRICING TEST WORK PAPER . . . . .</b>	14.116
<b>RECEIVABLES (see ACCOUNTS RECEIVABLE)</b>	
<b>RECENT AUTHORITATIVE PRONOUNCEMENTS (see NEW AUTHORITATIVE PRONOUNCEMENTS)</b>	
<b>REISSUANCE OF REPORT AS PREDECESSOR . . . . .</b>	19.510
<b>REISSUANCE OF REPORT SUBSEQUENT TO ORIGINAL ISSUE DATE . . . . .</b>	19.513
<b>RELIANCE LETTER . . . . .</b>	13.035
<b>RELIANCE MATRIX (TABLE) . . . . .</b>	3.105
<b>RELYING ON WORK OF A SPECIALIST . . . . .</b>	19.502
<b>REPORTS ON AUDITED FINANCIAL STATEMENTS (see AUDITORS' REPORTS)</b>	
<b>REPORTS ON COMPILED OR REVIEWED FINANCIAL STATEMENTS (see COMPILATION AND REVIEW REPORTS)</b>	
<b>RELATED PARTY CONFIRMATION . . . . .</b>	13.020
<b>RELATED PARTY TRANSACTIONS</b>	
Confirmation . . . . .	13.020
Disclosures . . . . .	17.203-17.205
Disclosure of Major Customer . . . . .	17.206-17.207
<b>REPORT ON REPORTABLE CONDITIONS . . . . .</b>	13.036
<b>REPORT ON REPORTABLE CONDITIONS THAT ALSO IDENTIFIES A MATERIAL WEAKNESS . . . . .</b>	13.037
<b>REPORT PREPARATION</b>	
Addressee . . . . .	19.004
Letterhead . . . . .	19.004
Level of Service . . . . .	19.004
Report Dating . . . . .	19.004
Report Signing . . . . .	19.004
Salutation . . . . .	19.004

<b>REPORTABLE CONDITIONS</b>			
Communication to Audit Committee	13.034	AICPA Guide on Audit Sampling	3.501, 3.506, 3.515, 3.548
Sample Report	13.036, 13.037	Approaches	3.544
Form	10.801	<b>SAMPLE SIZE SELECTION AND EVALUATION FORM</b>	10.506
Material Weaknesses	7.608	<b>SAMPLING DECISION WORKING PAPER</b>	10.504
Sample Report	13.037	<b>SCOPE LIMITATIONS</b>	
<b>REPORTING CHECKLIST (see FINANCIAL STATEMENTS AND NOTES CHECKLIST)</b>		First-Year Audits	19.104
<b>REPORTING ON AUDITED FINANCIAL STATEMENTS (see AUDITORS' REPORTS)</b>		Uncertainties	19.118
<b>REPORTING ON COMPILATION AND REVIEW ENGAGEMENTS (see COMPILATION AND REVIEW REPORTS)</b>		<b>SECURITIES HELD BY BROKERS CONFIRMATION</b>	13.010
<b>REPRESENTATION LETTER — AUDIT ENGAGEMENT</b>	13.032	<b>SEGMENTS OF A BUSINESS</b>	17.800
<b>REPRESENTATION LETTER — REVIEW ENGAGEMENT</b>	13.033	<b>SFAS (see STATEMENTS OF FINANCIAL ACCOUNTING STANDARDS)</b>	
<b>REPRESENTATION LETTER TO OTHER ACCOUNTANTS</b>	13.023	<b>SHAREHOLDERS' EQUITY</b>	17.600
<b>REQUEST FOR BANK CUTOFF STATEMENT</b>	13.002	Additional Paid-In Capital	17.604
<b>REPRESENTATION LETTERS</b>	5.700, 12.302	Capital Stock	17.603
Date	7.503	Dividends	17.607
Content	7.502	Retained Earnings	17.606
Requirements	7.502	Statement of	18.106-18.108
Requirement for Audit Engagements	5.700	Treasury Stock	17.605
Requirement for Review Engagements	4.400	<b>SICK LEAVE, ACCRUED EXPENSE (see COMPENSATED ABSENCES)</b>	
Sample Letter	13.032, 13.033	<b>SINGLE FINANCIAL STATEMENT</b>	19.501
SAS No. 19	7.502	Sample Reports	19.901, 19.625-19.626, 20.912, 20.934
<b>RESEARCH AND DEVELOPMENT COSTS</b>	17.712	<b>SSARS (see STATEMENTS ON STANDARDS FOR ACCOUNTING AND REVIEW SERVICES)</b>	
<b>RESTATEMENT</b>		<b>STANDARD AUDIT REPORT</b>	19.101
Change in Accounting Principle	19.113	<b>STANDARD COMPILATION REPORT</b>	20.902
Change in Reporting Entity	17.310	<b>STANDARD REVIEW REPORT</b>	20.926
Correction of an Error	17.717-17.718	<b>STANDARDS (see PROFESSIONAL STANDARDS)</b>	
Prior-Period	17.306	<b>STATEMENT OF CASH FLOWS</b>	17.900, 18.109-18.111
<b>RETAINED EARNINGS, STATEMENT OF</b>	18.106	Compilation and Review Engagements	4.706
<b>RETIREMENT PLANS (see PENSION PLANS; POSTEMPLOYMENT BENEFITS; POSTRETIREMENT BENEFITS)</b>		Statement Preparation	17.901
<b>REVIEW ENGAGEMENT WORK PROGRAM</b>	10.904	Working Paper	16.108
<b>REVIEW ENGAGEMENT ANALYTICAL PROCEDURES CHECKLIST</b>	10.905	<b>STATEMENT OF EARNINGS</b>	17.700, 18.104
<b>REVIEW REPORT, MODIFIED (see MODIFICATIONS TO STANDARD REVIEW REPORT)</b>		<b>STATEMENT OF RETAINED EARNINGS</b>	18.106-18.108
<b>REVIEW REPORT, STANDARD</b>	20.926	<b>STATEMENT OF SHAREHOLDERS' EQUITY</b>	17.600, 18.106-18.108
<b>RISK ASSESSMENT</b>	3.204	<b>STATEMENTS ON AUDITING STANDARDS (SAS)</b>	1.600
<b>RISK OF POTENTIAL MISSTATEMENTS (see ERRORS, IRREGULARITIES, AND ILLEGAL ACTS)</b>		SAS No. 1 (Various AU Sections)	7.207, 7.301, 12.301, 19.005
<b>RISK OF POTENTIAL MISSTATEMENTS EVALUATION FORM</b>	10.101	SAS No. 12 (AU Sec. 337)	7.201
<b>SAFE DEPOSIT ACCESS CONFIRMATION</b>	13.012	SAS No. 19 (AU Sec. 333)	7.502
<b>SAMPLING</b>		SAS No. 22 (AU Sec. 311)	2.303, 3.310, 8.003, 12.102
Acceptable Risk of Assessing Control		SAS No. 31 (AU Sec. 326)	2.303, 3.517
Risk Too Low	3.518	SAS No. 39 (AU Sec. 350)	2.303, 2.605, 3.411, 3.501, 5.004
		SAS No. 41 (AU Sec. 339)	2.303, 6.201, 6.209
		SAS No. 47 (AU Sec. 312)	2.303, 2.308, 7.401
		SAS No. 48 (AU Sec. 311)	2.303, 3.310
		SAS No. 53 (AU Sec. 316)	2.303, 2.308, 2.309-2.313, 2.607, 7.601, 7.614-7.617
		SAS No. 54 (AU Sec. 317)	2.303, 2.321-2.325, 2.607, 7.614-7.617
		SAS No. 55 (AU Sec. 319)	2.303, 2.306, 3.202, 3.303, 3.406
		SAS No. 56 (AU Sec. 329)	2.303, 7.102

<b>STATEMENTS ON AUDITING STANDARDS (SAS) (cont.)</b>	
SAS No. 57 (AU Sec. 342) . . . . .	2.303, 5.300
SAS No. 58 (AU Sec. 508) . . . . .	19.101, 19.117
SAS No. 59 (AU Sec. 341) . . . . .	2.303, 19.124
SAS No. 60 (AU Sec. 325) . . . . .	7.601, 7.607-7.611
SAS No. 61 (AU Sec. 380) . . . . .	7.601, 7.618, 13.034
SAS No. 62 (AU Sec. 623) . . . . .	4.707
SAS No. 64 (AU Secs. 341, 508, 543) . . . . .	19.124
SAS No. 67 (AU Sec. 330) . . . . .	2.303, 5.004, 5.200
SAS No. 69 (AU Sec. 411) . . . . .	1.500
SAS No. 70 (AU Sec. 324) . . . . .	2.303, 2.610
SAS No. 71 (AU Sec. 722) . . . . .	5.650-5.656
SAS No. 73 . . . . .	19.502
<b>STATEMENTS ON FINANCIAL ACCOUNTING STANDARDS (SFAS)</b>	
SFAS No. 5 . . . . .	7.202, 19.116
SFAS No. 13 . . . . .	17.545
SFAS No. 16 . . . . .	17.717-17.718
SFAS No. 21 . . . . .	17.703
SFAS No. 86 . . . . .	17.712
SFAS No. 87 . . . . .	5.401, 17.594
SFAS No. 88 . . . . .	5.401
SFAS No. 94 . . . . .	17.103
SFAS No. 95 . . . . .	4.706, 17.901
SFAS No. 106 . . . . .	5.501-5.503
SFAS No. 107 . . . . .	17.514-17.515
SFAS No. 109 . . . . .	17.578, 17.708
SFAS No. 112 . . . . .	5.601-5.602
SFAS No. 115 . . . . .	17.508-17.512
<b>STATEMENTS ON STANDARDS FOR ACCOUNTING AND REVIEW SERVICES (SSARS)</b>	
Listing . . . . .	4.800
Interpretations . . . . .	4.717
SSARS No. 1 . . . . .	1.602, 4.001-4.006, 4.101-4.104, 4.306, 4.701, 4.714-4.715, 4.717, 6.202, 20.216
SSARS No. 3 . . . . .	4.708-4.713
SSARS No. 7 . . . . .	4.401, 20.001
<b>STATEMENTS ON STANDARDS FOR ATTESTATION ENGAGEMENTS (SSAE)</b>	
SSAE No. 1 . . . . .	20.103
<b>STATISTICAL SAMPLING</b> . . . . .	3.529-3.536
<b>STOCK OPTION AND STOCK PURCHASE PLANS</b> . . . . .	17.597
Illustrative Disclosures . . . . .	17.597
<b>SUBSEQUENT DISCOVERY OF FACTS EXISTING AT REPORT DATE</b>	
Reissuance of Report . . . . .	19.513
<b>SUBSEQUENT EVENTS</b>	
Authoritative Literature . . . . .	12.301
Documentation . . . . .	12.304
Pooling of Interest Accounting . . . . .	17.115
Procedures . . . . .	12.302
Subsequent Events Review Program . . . . .	12.304
<b>SUBSEQUENT EVENTS REVIEW PROGRAM</b> . . . . .	12.304
<b>SUBSTANTIVE TESTS (see also ANALYTICAL PROCEDURES; TESTS OF BALANCES)</b>	
<b>SUCCESSOR AUDITORS AND ACCOUNTANTS</b>	
Evidence Accumulation . . . . .	6.209
First-Year Engagements . . . . .	2.501
Reporting Based on Other Auditor's Work . . . . .	2.515
<b>SUMMARY OF POSSIBLE JOURNAL ENTRIES</b> . . . . .	7.400
Adjustments . . . . .	7.403-7.406
Documentation Form . . . . .	10.302
Materiality Limits . . . . .	7.401
Misstatements (see also <b>ERRORS, IRREGULARITIES, AND ILLEGAL ACTS</b> )	
From Prior-Year . . . . .	7.404
Threshold for Posting . . . . .	7.405-7.406
Using the Summary . . . . .	7.407-7.410
<b>SUMMARY OF POSSIBLE JOURNAL ENTRIES FORM</b> . . . . .	10.302
<b>SUMMARY OF TIME SAVINGS FOR NEXT YEAR</b> . . . . .	11.202
<b>SUPERVISION AND REVIEW</b>	
Checklists, Supervision and Review . . . . .	12.200-12.704
Control Form . . . . .	12.604
Engagement Performance Review Checklist . . . . .	12.411
Executive Review . . . . .	8.105
Financial Statement Control Form . . . . .	12.604
In-charge Review . . . . .	8.104
Partner Review . . . . .	8.106-8.107
Procedures . . . . .	8.004
Quality Control Standards . . . . .	8.001, 12.101
SAS No. 22 . . . . .	8.003, 12.102
Subsequent Events . . . . .	12.300
Supervision and Review Checklists . . . . .	12.200-12.704
Tax Accrual/Provision Review Checklist . . . . .	12.200, 12.204
Technical Review . . . . .	12.500
Technical Review Checklist . . . . .	12.504
Working Papers Review . . . . .	8.100
<b>SUPPLEMENTAL REPORTING REQUIREMENTS</b> . . . . .	19.400
<b>SUPPLEMENTARY INFORMATION</b>	
Audits . . . . .	19.400
Compilations and Reviews . . . . .	20.801
Common Interest Realty Associations (CIRA) . . . . .	19.403-19.404
Sample Reports . . . . .	19.624
<b>SYSTEM A CLASSIFICATION</b> . . . . .	3.103-3.104, 3.307
<b>SYSTEM B CLASSIFICATION</b> . . . . .	3.103-3.104, 3.307
<b>SYSTEM C CLASSIFICATION</b> . . . . .	3.103-3.104, 3.112, 3.307
<b>TAX ACCRUAL/PROVISION REVIEW CHECKLIST</b>	
	12.200, 12.204
<b>TAX-EXEMPT ENTITIES</b> . . . . .	17.709
<b>TECHNICAL REVIEW CHECKLIST</b> . . . . .	12.504, 16.404
<b>TESTS OF BALANCES</b>	
All-Substantive Approach . . . . .	3.207, 3.403, 3.411
Audit Program . . . . .	10.700
Reduction of Tests . . . . .	3.403
Sampling Decisions . . . . .	3.538-3.543
Substantive Test . . . . .	3.205, 3.207
<b>TESTS OF BALANCES AUDIT PROGRAM</b> . . . . .	3.538, 10.700
<b>TESTS OF CONTROLS (see INTERNAL CONTROLS STRUCTURE)</b>	
<b>TESTS OF CONTROLS—CASH DISBURSEMENTS AND PURCHASES</b> . . . . .	
	10.400
<b>TESTS OF CONTROLS—PAYROLL</b> . . . . .	
	14.400
<b>TESTS OF CONTROLS PROGRAM</b> . . . . .	
	10.400

<b>TESTS OF CONTROLS — SALES TRANSACTIONS</b> . . . . .	14.125	<b>WORKING PAPERS (see also DOCUMENTATION; EVIDENCE ACCUMULATION)</b>	
<b>TICKMARKS, EXPLANATION OF</b> . . . . .	14.101	Accounts Receivable Aged Trial Balance . . . . .	14.110
<b>TIME ACCUMULATION SHEET</b> . . . . .	11.201	Accounts Receivable Confirmation Statistics . . . . .	14.112
<b>TIME CONTROL DOCUMENTS</b>		Allowance for Doubtful Accounts . . . . .	14.111
Budgets . . . . .	11.001, 11.100	Bank Reconciliation . . . . .	14.108
Summary of Time Savings for Next Year . . . . .	11.202	Bank Transfers . . . . .	14.109
Time Accumulation Sheet . . . . .	11.201	Cash on Hand . . . . .	14.107
Time Summary Form . . . . .	11.200	Client-Prepared Working Papers . . . . .	6.004
Using the Time Control Documents . . . . .	11.100	Correspondence Control . . . . .	14.102
<b>TIME SUMMARY FORM</b> . . . . .	11.200	Deficiencies . . . . .	6.209
<b>TRANSACTION CYCLES</b>		<b>WORKING PAPERS (see also DOCUMENTATION; EVIDENCE ACCUMULATION) (cont.)</b>	
Relationship to Major Audit Areas . . . . .	3.306	Investments in Securities . . . . .	
<b>TRIAL BALANCE PREPARATION</b>		14.121Lead Schedule . . . . .	14.106
Lead Sheet Method . . . . .	16.101	Notes Payable and Long-Term Debt . . . . .	14.122
Working Trial Balance Method . . . . .	16.101	Notes Receivable . . . . .	14.113
<b>UNCERTAINTIES</b> . . . . .	2.115-2.121	Pension Accounting . . . . .	14.128
Accountant's Reports . . . . .	20.700	Physical Inventory Cutoff Data . . . . .	14.115
Altman Z Score Form . . . . .	2.122-2.126, 10.304	Prepaid Insurance . . . . .	14.117
Auditor's Reports . . . . .	19.600	Preparation of . . . . .	6.300
Compilations and Reviews . . . . .	20.700	Property, Plant, and Equipment . . . . .	14.118
Departures From GAAP . . . . .	19.612	Additions . . . . .	14.119
Going-Concern Uncertainties . . . . .	19.612, 20.700	Disposals . . . . .	14.120
Resolution of the Uncertainty . . . . .	19.612	Raw Materials Pricing Test . . . . .	14.116
Scope Limitations . . . . .	19.613	Reconciliation of Book and Physical Inventories . . . . .	14.114
<b>UNCONSOLIDATED SUBSIDIARIES</b> . . . . .	17.104-17.106	Review of . . . . .	8.100
<b>UNIFORM COMMERCIAL CODE</b>		Rules and Techniques for Working Paper Preparation . . . . .	6.300
Confirmation Request . . . . .	13.021	Shareholders' Equity Analysis . . . . .	14.124
<b>UPDATED REPORT DIFFERS FROM PREVIOUS REPORT</b> . . . . .	19.507	Summary of Carryovers . . . . .	14.123
<b>VACATION TIME (see COMPENSATED ABSENCES)</b>		Statement of Cash Flows . . . . .	14.129
<b>WORDPERFECT DISKETTE</b> . . . . .	1.801	Tests of Controls — Cash Disbursements and Purchases . . . . .	14.126
<b>WORK OF OTHER AUDITORS</b> . . . . .	19.200	Tests of Controls — Payroll . . . . .	14.127
No Reference to Other Auditor . . . . .	19.204	Tests of Controls — Sales Transactions . . . . .	14.125
Procedures . . . . .	19.205	Working Paper Schedules . . . . .	6.005
Reference to Other Auditor . . . . .	19.203	Working Trial Balance — Assets . . . . .	14.103
Sample Report . . . . .	19.614	Working Trial Balance — Liabilities and Shareholders' Equity . . . . .	14.104
		Working Trial Balance — Revenues, Costs, and Expenses . . . . .	14.105
		<b>WORKING TRIAL BALANCE — ASSETS</b> . . . . .	14.103
		<b>WORKING TRIAL BALANCE — LIABILITIES AND SHAREHOLDERS' EQUITY</b> . . . . .	14.104
		<b>WORKING TRIAL BALANCE — REVENUES, COSTS, AND EXPENSES</b> . . . . .	14.105



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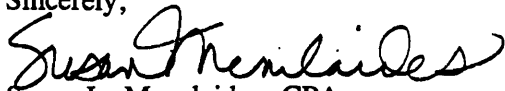
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Director, Technical Information Division

008869



**Comprehensive Engagement Manual  
Letters and Reports for WordPerfect Diskette  
and Forms in Lotus Files**

<u>Section</u>	<u>Description</u>	<u>File Name</u>
<b>Correspondence</b>		
13.002	Request for Bank Cutoff Statement	BANCUTOF
13.004	Money Market Fund Confirmation	MMFDCNF
13.005	Accounts Receivable Confirmation – Positive	ARPSCNF
13.006	Accounts Receivable Confirmation – Negative	ARNGCNF
13.007	Notes Receivable Confirmation-Positive	NRPSCNF
13.008	Inventories in Warehouse Confirmation Client Provided Listing	INVWCCNF
13.009	Inventories in Warehouse Confirmation – Client Did Not Provide Listing	INVWCNF
13.010	Securities Held By Brokers Confirmation	SECCNF
13.012	Safe Deposit Access Confirmation	SDACNF
13.013	Notes Payable/Long-Term Debt Confirmation	NPLTDCNF
13.014	Mortgage Debt Confirmation	MTGCNF
13.015	Accounts Payable Confirmation	APCNF
13.016	Lines of Credit Confirmation	LOCCNF
13.017	Contingent Liabilities Confirmation	CNTLBCNF
13.018	Registrar – Capital Stock Confirmation	CPSTKCNF
13.019	Transfer Agent – Capital Stock Confirmation	CPSTACNF
13.020	Related-Party Confirmation	RPCNF
13.022	Letter of Other Accountants Upon Whose Work We Plan to Rely	OACLTR
13.023	Representation Letter to Other Accountants	REPOACT
13.024	Engagement Letter – Audits	ENGLETA
13.025	Engagement Letter – Compilations	ENGLETC
13.026	Engagement Letter – Reviews	ENGLETR
13.027	Proposal Letter	PROPLTR
13.028	Inquiry Letter to Legal Counsel – General	LAWINQ
13.029	Inquiry Letter to Legal Counsel – Management Did Not Provide Pending Litigation Details	LAWINQLT
13.030	Pension Plan Actuarial Information	PENSPLAC
13.031	Pension Plan Assets Held by Trustee	PENSPLAS
13.032	Representation Letter – Audits	REPLETA
13.033	Representation Letter – Reviews	REPLETR
13.034	Communication With Audit Committees	AUDCOMCM
13.035	Reliance Letter	RELLTR
13.036	Reportable Conditions Report	REPCOND
13.037	Reportable Conditions Report – Identifies Material Weaknesses	REPCNDMW

<u>Section</u>	<u>Description</u>	<u>File Name</u>
13.038	Insurance In-Force Confirmation	INSCONF
13.039	Letter to Actuary Requesting Employer's Benefit Cost Information	ACTLETT
<b>Auditor's Reports</b>		
19.601	Standard Auditor's Report – Single Period	AUDRPSF
19.602	Standard Auditor's Report – Comparative Periods	AUDRPCP
19.603	Qualified Opinion – Scope Limitation	QRPSLT
19.604	Disclaimer of Opinion – Scope Limitation	DSCRPSLT
19.605	First-Year Audit – Beginning Balances Not Audited	SLTBB
19.606	Qualified Opinion – GAAP Departure	GAAPDQRP
19.607	Adverse Opinion – GAAP Departure	GAAPDARP
19.608	Qualified Opinion – Inadequate Disclosure	DISCLQRP
19.609	Explanatory Paragraph – Change of GAAP	EXPGAAP
19.610	Qualified Opinion – Change to Unacceptable Principle	DGAAPQRP
19.611	Qualified Opinion – Client Does Not Provide Justification for Change in Principle	JPQRP
19.612	Uncertainty	
19.613	Going-Concern Uncertainty Paragraph	GNGCNCR
19.614	Report Indicating Divided Responsibility Among Auditors	DRARP
19.615	Predecessor Declines Reissue – Prior Period Unqualified	PREPPUNQ
19.616	Predecessor Declines Reissue – Prior Period Qualified	PREPPQ
19.617	Predecessor Declines Reissue – Prior Period Unqualified; Restatement Subsequently Made	PREPPQR
19.618	Current Period Audited – Prior Period Reviewed	AUDREV
19.619	Current Year Audited – Prior Period Compiled	AUDCOMP
19.620	Supplementary Information – Unqualified Report	SUPPUNQ
19.621	Supplementary Information – Disclaimer on Part	SUPPDISC
19.622	Supplementary Information – Disclaimer on All	SUPPDISQ
19.623	Report on Basic Financial Statements Qualified; Supplementary Information Qualified	QUALSUPP
19.624	CIRA Financial Statements – Required Supplementary Information Omitted	CIRAOM
19.625	Balance Sheet Only Presented	BSRPT

<u>Section</u>	<u>Description</u>	<u>File Name</u>
19.626	Balance Sheet Only Report – Disclaimer on Other Statements	BSRPTDIS
19.627	Lack of Independence (Public Companies)	NOIND
19.628	Emphasis of a Matter	EMPMATT
19.629	Restatement of Prior Period to Conform to GAAP	PPREST
<b>Compilation and Review Reports</b>		
20.902	Standard Compilation Report	COMPRPT
20.903	Compilation Report – Disclosures Omitted	COMPNODS
20.904	Compilation Report – GAAP Departure Effect Determined	COMPGAAP
20.905	Compilation Report – GAAP Departure Effect Not Determined	COMPGAPN
20.906	Compilation Report – Statement of Cash Flows Omitted	COMPNOCF
20.907	Compilation Report – Changed Reference to Prior Period GAAP Departure	COMPPPGP
20.908	Comparative Compilation Report – Disclosures Omitted	COMPCOM
20.909	Compilation Current Period – Review Prior Period	COMPREV
20.910	Compilation Current Period – Audit Prior Period	COMPAUD
20.911	Compilation Report – Prior Period Compiled by Other Accountants	COMPPPOA
20.912	Compilation Report – Balance Sheet Only	COMPBS
20.913	Compilation Report – Supplementary Information Included	COMPSUPP
20.914	Compilation Report – Income Tax Basis	COMPIT
20.915	Compilation Report – Cash Basis	COMPCASH
20.916	Compilation Report on Elements, Accounts, or Items of a Financial Statement	COMPELEM
20.917	Compilation Report – Special Purpose – Acquisition Agreement	COMPACQ
20.918	Compilation Report – Prescribed Form	COMPPRSC
20.926	Standard Review Report	REVRPT
20.927	Review Report – GAAP Departure Effect Determined	REVGAAAP
20.928	Review Report – GAAP Departure Effect Not Determined	REVNGAAAP
20.929	Review Report – Statement of Cash Flows Omitted	REVNOCF
20.930	Review Report – Changed Reference to Prior Period GAAP Departure	REVPPGAP
20.931	Review Current Period – Audit Prior Period	REVAUD
20.932	Review Current Period – Prior Period Compiled	REVCOMP

<u>Section</u>	<u>Description</u>	<u>File Name</u>
20.933	Review Report - Prior Period Reviewed by Other Accountants	REVREV
20.934	Review Report - Balance Sheet Only	REVBS
20.935	Review Report - Supplementary Information Reviewed	REVSUPP
20.936	Review Report - Supplementary Information Not Reviewed	REVNSUPP
20.937	Review Report - Income Tax Basis	REVIT
20.938	Review Report - Cash Basis	REVCASH
20.939	Review Report - Special Purpose - Acquisition Agreement	REVACQ
<b>Lotus Files</b>		
10.302	Summary of Possible Journal Entries Form	CEMSJE1.WK3
10.302	Summary of Possible Journal Entries Form (WYSIWYG Print File)	CEMSJE1.FM3