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AICPA audit and accounting manual : nonauthoritative technical practice aids, as of June 1, 1994

American Institute of Certified Public Accountants (AICPA)

AICPA AUDIT AND ACCOUNTING MANUAL As of June 1, 1994

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Nonauthoritative Practice Aids

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Nonauthoritative Practice Aids

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HOW TO USE THIS VOLUME

Scope of the Volume . . .

This volume, which is a reprint of the looseleaf edition, brings together for continuing reference a set of nonauthoritative audit tools and illustrations prepared by the staff of the Technical Information Division of the American Institute of Certified Public Accountants.

How This Volume Is Arranged . . .

The contents of this Volume are arranged as follows:

Introduction

Compilation and Review

Engagement Planning and Administration

Internal Control Structure

Audit Approach and Programs

Working Papers

Correspondence, Confirmations & Representations

Audit Risk Alert

Supervision, Review and Report Processing

Accountants' Reports

Quality Control Forms and Aids

How to Use This Volume . . .

The arrangement of material is indicated in the general table of contents at the front of the Volume. There is a detailed table of contents covering the material within each major division.

The major divisions are subdivided into sections, each with its own section number. Each paragraph within a section is decimally numbered. For example, AAM section 7100.01 refers to the first paragraph of section 7100, *Control of Confirmations and Correspondence.* Section and paragraph numbers located on each page are provided as corner references at the bottom of each page.

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

The *FASB Accounting Standards Current Text* is referenced in a similar manner by the use of the abbreviation AC before the section and paragraph numbers. The *Current Text* contains an abridged version of the currently effective financial and reporting standards, as amended.

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

The Appendixes provide cross references from pronouncements of the American Institute of Certified Public Accountants, the Securities and Exchange Commission, the Financial Accounting Standards Board, the Governmental Accounting Standards Board, and the National Council on Governmental Accounting to sections in the text.

The Topical Index uses the key word method to facilitate reference to audit tools and illustrations. The index is arranged by topic and refers the reader to major divisions, sections, and paragraph numbers.

AAM Section 1000

INTRODUCTION

This manual has not been approved, disapproved, or otherwise acted upon by any senior technical committees of the American Institute of Certified Public Accountants or the Financial Accounting Standards Board and has no official or authoritative status.

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AAM Section 1100

Introduction

.01 This manual has been prepared by the staff of the American Institute of Certified Public Accountants and issued as a nonauthoritative practice aid. The materials included in it are designed to serve as working tools and illustrations for timesaving purposes. They are not intended as a substitute for the professional judgments that must be applied by practitioners. The manual, where practicable, offers choices and alternatives rather than particular positions. The manual is not a substitute for the authoritative technical literature and users are urged to refer directly to applicable authoritative pronouncements for the text of technical standards.

.02 Some sections of the manual include quotations from Statements on Auditing Standards and other authoritative pronouncements. Those quotations are intended only to illustrate certain matters, not to serve as a substitute for careful study of the relevent pronouncements. References are made throughout the manual to the original authoritative pronouncements and to their section numbers in *AICPA Professional Standards* and the *FASB Accounting Standards Current Text* to help users locate those authoritative pronouncements.

.03 The authors hope that the manual will be helpful to practitioners in the conduct of their audit and accounting practice. However, no generalized material, such as that included in this manual, can be a substitute for development and implementation by a firm of a system of quality control which is appropriately comprehensive and suitably designed in relation to the firm's organizational structure, its policies, and the nature of its practice.

.04 The manual is in looseleaf format in anticipation of updating and expansion. Changes are expected to arise from three main sources:

(1) Comments and suggestions from practitioners. Since this manual is a product of AICPA staff, not of a committee of practitioners, it is particularly important that practitioners advise the staff on any suggestions for material that could be improved or added.

(2) Issuance of new official pronouncements.

(3) Other additions to or deletions from the manual as a result of continued staff study.

Comments and suggestions should be addressed to:

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201 Plaza III
Jersey City, NJ 07311-3881

or call Moshe S. Levitin at (201) 938-3064.

.05 For disclosure checklists and illustrative financial statements, obtain the AICPA looseleaf service entitled *Financial Statement Preparation Manual.* This manual includes disclosure checklists and illustrative financial statements for the following:

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AAM Section 1200
How to Use the Audit and Accounting Manual

Overview

.01 The Audit and Accounting Manual (AAM) is designed to provide practitioners assistance for audit, review, and compilation engagements. The AAM is comprised of the following sections:

Section No.	*Section Name*
2000	Compilation and Review
3000	Engagement Planning & Administration
4000	Internal Control Structure
5000	Audit Approach & Programs
6000	Working Papers
7000	Correspondence, Confirmations & Representations
8000	Audit Risk Alert
9000	Supervision, Review & Report Processing
10,000	Accountants' Reports
11,000	Quality Control Forms and Aids

Audits

.02 To perform an engagement in accordance with generally accepted auditing standards (GAAS) an auditor must comply with the General Standards, the Standards of Field Work, the Standards of Reporting, and the Quality Control Standards.

.03 The general standards are concerned with the qualifications of the auditor and the qualitative aspect of the work performed. They specifically address the auditor's training and proficiency, independence, and due care in the performance of work.

.04 The standards of field work address the manner used by the auditor to perform the audit. This standard begins with the appointment of the auditor and ends with the auditor communicating to those responsible for the oversight of financial reporting of the entity being audited.

.05 The standards of reporting are concerned with the opinion the auditor renders on the client's financial statements.

.06 The AAM will assist the auditor in performing an audit, in accordance with GAAS, in the following ways:

a. The Quality Control Forms and Aids section [AAM section 11,000] includes sample forms which can be used by a firm to document its adherence to the AICPA requirement for a System of Quality Control for a CPA Firm. Included in this section are forms that relate to the nine elements of Quality Control:

Independence	Assigning Personnel to Engagements
Consultation	Supervision
Hiring	Professional Development
Advancement	Acceptance and Continuance of Clients
Inspection	

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

c. The Internal Control Structure section [AAM section 4000] provides guidance in evaluating the internal control structure by utilizing checklists, questionnaires, and other generalized aids.

d. The Audit Approach & Programs section [AAM section 5000] explains how the auditor should design audit programs as well as providing an illustrative audit program which can be used to assist the auditor in designing an audit program for his specific clients.

e. The Working Papers section [AAM section 6000] provides the auditor with a general discussion of the purpose of working papers as well as examples of numerous working papers to assist the auditor in designing the working papers that are considered necessary in the audit being performed.

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

g. The Supervision, Review & Report Processing section [AAM section 9000] provides the auditor with an overview of supervision and review procedures as well as engagement review programs for the in-charge accountant and the partner responsible for the engagement. It also provides procedures for processing the report.

h. The Accountants' Reports section [AAM section 10,000] addresses the format of the accountants' report and numerous examples of the auditor's report.

Compilation and Review Services

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

.08 SSARS 1, *Compilation and Review of Financial Statements* [AR section 100], provides guidance to accountants concerning the standards and procedures applicable to compilation and review services for a nonpublic entity. The statement also provides examples of standard single year reports and departures from those reports.

.09 SSARS 2, *Reporting on Comparative Financial Statements* [AR section 200], establishes standards for reporting on comparative financial statements of a nonpublic entity when one or more prior periods have been compiled or reviewed in accordance with SSARS 1 [AR section 100].

.10 SSARS 3, *Compilation Reports on Financial Statements Included in Certain Prescribed Forms* [AR section 300], provides an alternative form of standard compilation report when reporting on a prescribed form calls for a departure from generally accepted accounting principles (GAAP).

.11 SSARS 4, *Communications Between Predecessor and Successor Accountants* [AR section 400], provides guidance to a successor accountant who communicates with a predecessor accountant regarding acceptance of an engagement to compile or review financial statements of a nonpublic entity.

.12 SSARS 5 (Deleted by SSARS 7).

.13 SSARS 6, *Reporting on Personal Financial Statements Included in Written Personal Financial Plans* [AR section 600], provides an exemption from SSARS 1 for personal financial plans.

.14 SSARS 7, *Omnibus Statement on Standards for Accounting and Review Services—1992.*

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

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

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

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

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

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

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

Working Papers [AAM section 6000]

Correspondence, Confirmations & Representations [AAM section 7000]

Accountants' Reports [AAM section 10,000]

Quality Control Forms and Aids [AAM section 11,000]

Audit Risk Alerts

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

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AAM Section 2000

COMPILATION AND REVIEW

This manual is a nonauthoritative kit of practice aids and, accordingly, does not include extensive explanation or discussion of authoritative pronouncements. Users of this manual are urged to refer directly to applicable authoritative pronouncements when appropriate.

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

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AAM Section 2100
Introduction

.01 Statements on Standards for Accounting and Review Services (SSARS) are issued by the American Institute of Certified Public Accountants (AICPA) Accounting and Review Services Committee (ARSC), the senior technical committee of the AICPA designated by its Council to issue pronouncements in connection with unaudited financial statements and other unaudited financial information of nonpublic entities (a complete listing of SSARS and the full text can be found in AICPA *Professional Standards,* volume 2, section AR). A nonpublic entity is defined as any entity other than (a) one whose securities trade in a public market either on a stock exchange or over the counter, (b) one that files with a regulatory agency in preparation for the sale of any class of its securities in a public market, or (c) any entity controlled by an entity covered by (a) or (b).

.02 Although, SSARS applies only to engagements involving nonpublic entities, there are circumstances when an accountant may perform a review of financial statements of a public entity under SSARS. SSARS 7, *Omnibus Statement on Standards for Accounting and Review Services—1992,* paragraph 1 (AR section 100.01), notes that when a public entity does not have its annual financial statements audited, an accountant may review the entity's annual or interim financial statements in accordance with SSARS as permitted by footnote 4 of Statements on Auditing Standards (SAS) No. 26, *Association With Financial Statements* (AU section 504.05).

.03 As of February 1994, ARSC had issued seven Statements on Standards for Accounting and Review Services. They are

- SSARS 1 — *Compilation and Review of Financial Statements* [AR section 100] (12/78)
- SSARS 2 — *Reporting on Comparative Financial Statements* [AR section 200] (10/79)
- SSARS 3 — *Compilation Reports on Financial Statements Included in Certain Prescribed Forms* [AR section 300] (12/81)
- SSARS 4 — *Communications Between Predecessor and Successor Accountants* [AR section 400] (12/81)
- SSARS 5 — (Deleted by SSARS 7)
- SSARS 6 — *Reporting on Personal Financial Statements Included in Written Personal Financial Plans* [AR section 600] (9/86)
- SSARS 7 — *Omnibus Statement on Standards for Accounting and Review Services—1992* (11/92)

.04 SSARS 1 (AR section 100) defines a compilation of financial statements and a review of financial statements and is effective for compilations and reviews of financial statements for periods ending on or after July 1, 1979. A compilation of financial statements is defined as presenting in the form of financial statements information that is the representation of management without expressing any assurance on the statements. A review of financial statements involves performing inquiry and analytical procedures to provide the accountant with a reasonable basis for expressing limited assurance that there are no material modifications that should be made to the financial statements necessary for them to be in conformity with generally accepted accounting principles.

.05 SSARS 1, paragraph 4 (AR section 100.04) [in part, as amended by SSARS 7], defines a financial statement as:

> A presentation of financial data, including accompanying notes, derived from accounting records and intended to communicate an entity's economic resources or obligations at a point in time, or the changes therein for a period of time, in accordance with generally

accepted accounting principles [1] or a comprehensive basis of accounting other than generally accepted accounting principles.[2] Financial forecasts, projections and similar presentations,[3] and financial presentations included in tax returns are not financial statements for purposes of this statement. The following presentations are examples of financial statements: [4]

a. Balance sheet

b. Statement of income

c. Statement of retained earnings

d. Statement of cash flows

e. Statement of changes in owners' equity

f. Statement of assets and liabilities (with or without owners' equity accounts)

g. Statement of revenues and expenses

h. Summary of operations

i. Statement of operations by product lines

j. Statement of cash receipts and disbursements

.06 SSARS 2 (AR section 200) establishes the standards for reporting on comparative financial statements of a nonpublic entity when the statements of one or more periods have been compiled or reviewed under SSARS 1 (AR section 100). SSARS 2 is effective for reports on comparative financial statements for periods ending on or after July 1, 1979.

.07 SSARS 3 (AR section 300) amends SSARS 1 and 2 (AR sections 100 and 200) to provide an alternative form of compilation report when a prescribed form calls for a departure from generally accepted accounting principles (GAAP). SSARS 3, paragraph 2 (AR section 300.02), defines a prescribed form as any preprinted form designed or adopted by the body to which it is intended to be submitted (e.g., banks, governmental bodies, etc.). Since this statement contains no effective date, it became effective upon issuance.

.08 SSARS 3 (AR section 300) does not prohibit the accountant from issuing a SSARS 1 (AR Section 100) compilation report which identifies GAAP departures in accordance with SSARS 1, paragraphs 39 through 41 (AR section 100.39—.41). A SSARS 3 report is specifically designed to provide an alternative form of reporting when a prescribed form calls for a GAAP departure.

.09 SSARS 4 (AR section 400), as amended by SSARS 7, provides guidance on required as well as optional communications between predecessor and successor accountants. SSARS 7 amended SSARS 4 (AR section 400) to require the successor accountant to request the client to communicate with the predecessor accountant, if the successor accountant becomes aware of information that may require revision of financial statements reported on by the predecessor accountant.

.10 SSARS 5 (Deleted by SSARS 7).

[1] The definition of generally accepted accounting principles and the hierarchy of established accounting principles presented in SAS No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report* (AU section 411), is also applicable to compilations and reviews of financial statements performed under SSARSs.

[2] The term *comprehensive basis of accounting other than generally accepted accounting principles* is defined in SAS No. 62, *Special Reports*, paragraph 4 (AU section 623.04) . . . reference to generally accepted accounting principles . . . includes, where applicable, another comprehensive basis of accounting. . . .

[3] Statement on Standards for Attestation Engagements No. 1, *Attestation Standards* (AT section 200), as well as the AICPA *Guide for Prospective Financial Information*, provide guidance on preparing and reporting on financial forecasts, projections, and similar presentations.

[4] SAS No. 62, paragraph 7 (AU section 623.07), provides guidance with respect to suitable titles for financial statements that are prepared in conformity with a comprehensive basis of accounting other than generally accepted accounting principles.

.11 SSARS 6 (AR section 600) provides an exemption from SSARS 1 (AR section 100) for personal financial statements included in personal financial plans. SSARS 6 was issued with no effective date, therefore, it became effective upon issuance.

.12 Under SSARS 6 (AR section 600), an accountant may submit a written personal financial plan containing unaudited personal financial statements to a client without issuing a report under SSARS 1 (AR section 100), as amended, when—

a. The accountant establishes an understanding with the client that the financial statements (i) will be used solely to assist the client and the client's advisors to develop the client's personal financial goals and objectives and (ii) will not be used to obtain credit or for any purpose other than developing the aforementioned goals and objectives.

b. Nothing comes to the accountant's attention during the engagement that would cause him or her to believe that the financial statements will be used to obtain credit or for any purposes other than developing the client's financial goals and objectives.

.13 An accountant following the exemption under SSARS 6 (AR section 600) should issue a written report stating that the unaudited financial statements—

a. Are designed solely to help develop the financial plan.

b. May be incomplete or contain departures from GAAP and should not be used to obtain credit or for any purpose other than developing the plan.

c. Have not been audited, reviewed, or compiled.

.14 SSARS 7, which is an omnibus statement—

a. Clarifies the applicability of SSARS 1 [AR section 100] by indicating that, in certain circumstances, an accountant may perform a review of a public company under the provisions of SSARSs.

b. Eliminates the prohibition against merely typing or reproducing financial statements without modification and defines the phrase *submission of financial statements.*

c. Makes explicit that the accountant is not required to communicate to a client errors that are not material and irregularities or illegal acts that are clearly inconsequential.

d. Modifies the SSARS review report to differentiate it from the review report presented in SAS No. 71, *Interim Financial Information* [AU section 722], as well as modifying the review and compilation report to clarify that the standards referred to in the reports are Statements on Standards for Accounting and Review Services.

e. Requires a client representation letter when performing a review engagement under SSARS.

f. Clarifies the accountant's reporting responsibilities in a compilation or review engagement when he or she decides there is an uncertainty about an entity's ability to continue as a going concern.

.15 Illustrative reports to be issued under the provisions of SSARS 1 through 7 can be found in AAM sections 10,400 and 10,500.

[The next page is 2201.]

AAM Section 2200
Engagement Planning and Administration

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

A. *Professional Competence.* Undertake only those professional services that the member or the member's firm can reasonably expect to be completed with professional competence.

B. *Due Professional Care.* Exercise due professional care in the performance of professional services.

C. *Planning and Supervision.* Adequately plan and supervise the performance of professional services.

D. *Sufficient Relevant Data.* Obtain sufficient relevant data to afford a reasonable basis for conclusions or recommendations in relation to any professional services performed.

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

.03 Prior to accepting an engagement to perform a compilation or review for a prospective client, the accountant should consider if he or she wishes to be associated with the client. Factors such as the ability of the accountant to adequately serve the client, the fee arrangement, client integrity, etc., need to be considered. It is often useful to complete a "Client Acceptance Form" to assist in determining whether or not to accept a client. An illustrative client acceptance form can be found in AAM section 2200.21.

Understanding the Engagement

.04 SSARS 1, paragraph 8 (AR section 100.08), states that the accountant should establish an understanding with the entity regarding the services to be performed. This understanding should include a description of the nature and limitations of the services to be performed, and a description of the report the accountant expects to render. The understanding should also include an explanation that the engagement cannot be relied upon to disclose errors, irregularities, or illegal acts but should also indicate that if any such matters, that are not inconsequential, come to the accountant's attention, the appropriate level of management will be notified. It is preferable that the understanding be in writing.

.05 It is a requirement of SSARS 1 (AR section 100) that an accountant have a knowledge of the entity's business when performing a compilation or review of its financial statements. The accountant should also possess a level of knowledge of the accounting principles and practices in the industry in which the entity operates. Many accountants find it helpful to complete a "Client Information Form" for their workpapers to document their understanding of the client. An illustrative form can be found in AAM section 2200.22.

Engagement Letters

.06 An engagement letter provides a means of formalizing the understanding between the accountant and the client concerning the services to be rendered. An engagement letter may serve to help reduce or eliminate client misunderstanding and potential legal liability. Illustrative engagement letters for compilation and review engagements can be found in AAM section 2200.23 and .24, respectively.

.07 An engagement letter may cover various services to be rendered. For example, an accountant who performs monthly compilations and a year-end review for a given client, may issue only one engagement letter for that client detailing all services to be performed.

Change in Engagement Level of Service

.08 An accountant who has been engaged to perform audit services with respect to financial statements may be requested by his or her client to change the level of service to be performed. SSARS 1, paragraphs 44 through 49 (AR section 100.44—.49), addresses changing the level of service to a lower level. A request to change the engagement to a review or a compilation may result from a change in circumstances affecting the entity's need for an audit (review), a misunderstanding of the nature of an audit, review, or compilation or a restriction on the scope of the audit (review), whether imposed by the client or caused by the circumstances.

.09 SSARS 1, paragraph 45 (AR section 100.45), states that before an accountant who was engaged to perform an audit or a review agrees to change the engagement to a review or compilation, at least the following factors should be considered:

a. The reason given for the client's request, particularly the implications of a restriction on the scope of the audit (review).

b. The additional audit effort required to complete the audit (review).

c. The estimated additional cost to complete the audit (review).

.10 A change in circumstances affecting the entity's need for an audit (review) or a misunderstanding of the nature of an audit, review, or compilation would normally be viewed as a reasonable basis for requesting a change in the level of service.

.11 The accountant should consider the implications of a restriction on the scope of the audit (review) and should evaluate the possibility that information affected by the scope restriction may be incorrect, incomplete, or otherwise unsatisfactory. The following two circumstances would ordinarily preclude an accountant from lowering his or her level of service—

1. When the accountant has been engaged to audit an entity's financial statements and has been prohibited by the client from corresponding with the entity's legal counsel, the accountant is precluded from issuing a review or compilation report on the financial statements.

2. For either an audit or review engagement, if the client refuses to provide the accountant with a signed representation letter, the accountant would be precluded from issuing a review report on the financial statements and would ordinarily be precluded from issuing a compilation report on the financial statements.

.12 SSARS 1, paragraph 48 (AR section 100.48), states that in all circumstances, if the auditing (review) procedures are virtually complete or the cost to complete such procedures is relatively insignificant, the accountant should consider the propriety of accepting a change in the engagement.

.13 If the accountant agrees that there is reasonable justification to change the engagement and he or she complies with the standards applicable to the changed engagement, the accountant should issue an appropriate review or compilation report. The report should not include reference to:

a. the original engagement,

b. any auditing or review procedures that may have been performed, or

c. scope limitations that resulted in the changed engagement.

.14 Interpretation 1 of SSARS 1, "Omission of Disclosures in Reviewed Financial Statements" (AR section 9100.01—.02), requires an accountant who undertakes to review financial statements and subsequently finds that his client declines to include substantially all required disclosures, to include the disclosures in his review report. If the disclosures are not known, the report should specifically identify the nature of the omitted disclosures. However, SSARS 1, paragraph 19 [AR section 100.19], permits an accountant to compile financial statements that omit substantially all disclosures provided the omission is not undertaken with the intent to mislead.

.15 The issue of changing the level of an engagement to a higher level of service is not specifically addressed in SSARS 1 (AR section 100). It is generally agreed that a change to a higher level of service is acceptable. In such circumstances, the accountant should be certain that it is possible to comply with the applicable standards for the revised level of service. It is also wise to revise the accountant's understanding with the client of the changed engagement, preferably by amending the engagement letter.

Predecessor and Successor Accountant

.16 SSARS 4 (AR section 400), as amended by SSARS 7, provides guidance to a successor accountant who decides to communicate with a predecessor accountant regarding acceptance of a compilation or review engagement. This statement requires the predecessor accountant to respond promptly and fully in the event of such communications.

.17 It also requires that a successor accountant who becomes aware of information that leads him or her to believe the financial statements reported on by the predecessor accountant may require revision to request that the client communicate this information to the predecessor accountant.

.18 The inquiries of the successor accountant will normally include questions concerning: (1) information that might bear on the integrity of management (owners); (2) disagreements with management (owners) about accounting principles or the necessity of performing certain procedures; (3) the cooperation of management in providing additional or revised information, when necessary; and (4) the predecessor's understanding of the reasons for the change of accountants.

.19 The predecessor accountant is expected to respond both promptly and fully to requests of the type cited above. Valid business reasons (e.g., unpaid fees) may preclude the predecessor from responding to the inquiries of the successor. The predecessor may also decide, due to unusual circumstances such as impending litigation, not to respond fully to the successor. In such an instance, the predecessor should indicate that the response is limited and the successor should consider both the reasons for and implications of such a response in deciding whether to undertake the engagement.

.20

Client Acceptance and Continuance Form—Part I

Client: ______________________

Financial Statement Date: ______________________

INSTRUCTIONS:

This form should be completed for all prospective clients for which audit, review, or compilation services are to be performed. The data on the form should be reviewed as a basis for initially accepting the client. The form should be updated and reviewed annually as a basis for deciding to retain the client.

CLIENT'S LEGAL NAME:

ADDRESS:

PHONE:

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

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

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

(continued)

Client Acceptance and Continuance Form—Part I (continued)

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

Name	Percent Owned	Position	Family Relationship

4. Identify any related businesses or individuals:

Name	Nature of Relationship

5. Identify the client's predecessor accountants:

Name:
Address:
Contact Person:

6. Indicate the results of our inquiries of the predecessor accountant regarding the following:
   a. Reasons for change of accountant: ______________________________
   ____
   ____
   b. Integrity of management: ______________________________
   ____
   ____
   c. Disagreements on accounting principles and auditing, review, or compilation procedures: ______________
   ____
   ____

(continued)

Client Acceptance and Continuance Form—Part I (continued)

d. Fee disputes: ______________________________

____

____

7. Describe the client's relationships with financial institutions:

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

8. Describe the services to be provided:

Service	How Often?			Report Deadlines
	Monthly	Quarterly	Annually	

Other Services:

Consulting services: ______________________________

Federal tax returns: ______________________________

State tax returns: ______________________________

Payroll tax returns: ______________________________

Tax returns for principal owners: ______________________________

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

Describe the use of the financial statements:

(continued)

Client Acceptance and Continuance Form—Part I (continued)

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

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

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

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

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

(continued)

Client Acceptance and Continuance Form—Part I (continued)

15. Identify the client's legal counsel:

Name:
Address:
Contact person:

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

17. Describe the billing arrangements:

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

(continued)

Client Acceptance and Continuance Form—Part I (continued)

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

	19 ____	19 ____	19 ____	19 ____	19 ____
Prepared or updated by: In-Charge	______	______	______	______	______
Reviewed by: Engagement Executive	______	______	______	______	______

Client Acceptance and Continuance Form—Part II

Client: ______________________________

Financial Statement Date: ______________________________

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

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

Acceptance Decision:

Yes ____ No ____

Engagement Partner: ______________________________ Date: __________

Concurring Partner: ______________________________ Date: __________

.21 Illustrative Engagement Letter for a Compilation

SWIFT, MARCH & COMPANY Certified Public Accountants

[Date]

Mr. Tom Jones, President
ZYXWV Freight Corporation
648 Crystal Lane
Noplace, Anystate 00000

Dear Mr. Jones:

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

We will perform the following services:

1. We will compile, from information you provide, the annual and interim balance sheets and related statements of income, retained earnings and cash flows of ZYXWV Freight Corporation for the year 19XX. We will not audit or review such financial statements. Our report on the annual financial statements of ZYXWV Freight Corporation is presently expected to read as follows:

    > We have compiled the accompanying balance sheet of XYZ Company as of December 31, 19XX, and the related statements of income, retained earnings and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.
    >
    > A compilation is limited to presenting in the form of financial statements information that is the representation of management (owners). 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.

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

    > Management has elected to omit substantially all of the disclosures 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.

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

2. We will assist your bookkeeper in adjusting the books of account so that he (she) will be able to prepare a working trial balance from which financial statements can be compiled. Your bookkeeper will provide us with a detailed trial balance and any supporting schedules we require.

3. We will also prepare the federal and state [*identify states*] income tax returns for ZYXWV Freight Corporation for the fiscal year ended December 31, 19XX.

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

Our fees for these services....

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

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

Sincerely yours,

____
(Signature of Accountant)

Acknowledged:

ZYXWV Freight Corporation

____
President

____
Date

*Some accountants prefer not to obtain an acknowledgment, in which case their letter would omit the paragraph beginning "If the foregoing..." and the spaces for the acknowledgment. The first paragraph of their letter might begin as follows: "This letter sets forth our understanding of the terms and objectives of our engagement..."

.22 Illustrative Engagement Letter for a Review

SWIFT, MARCH & COMPANY Certified Public Accountants

[Date]

Mr. Tom Jones, President
ZYXWV Freight Company
648 Crystal Lane
Nowhere, Anystate 00000

Dear Mr. Jones:

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

We will perform the following services:

1. We will review the balance sheet of ZYXWV Freight Company as of [*date*], 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. Our review will consist primarily of inquiries of company personnel and analytical procedures and we will require a client representation letter from you. A review does not contemplate obtaining an understanding of the internal control structure or assessing control risk, tests of accounting records and responses to inquiries by obtaining corroborating evidential matter, and certain other procedures ordinarily performed during an audit. Thus, a review does not provide assurance that we will become aware of all significant matters that would be disclosed in an audit. Our engagement cannot be relied upon to disclose errors, irregularities, or illegal acts, including fraud or defalcations, that may exist. However, we will inform the appropriate level of management of any material errors that come to our attention and any irregularities or illegal acts that come to our attention, unless they are clearly inconsequential. We will not perform an audit of such financial statements, the objective of which is the expression of an opinion regarding the financial statements taken as a whole, and, accordingly, we will not express such an opinion on them.

Our report is presently expected to read as follows:

> We have reviewed the accompanying balance sheet of ZYXWV Freight Company as of [*date*], and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management of ZYXWV Freight Company.
>
> A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly we do not express such an opinion.
>
> Based on our review, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.

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

2. We will provide your chief accountant with such consultation on accounting matters as may be required in adjusting and closing the books of account and in drafting financial statements for our review. Your chief accountant also will provide us with a detailed trial balance and any supporting schedules we require.

3. We will also prepare the federal and state [*identify states*] income tax returns for ZYXWV Freight Company for the fiscal year ended [*date*].

Our fees for these services....

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

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

Sincerely yours,

____

(Signature of Accountant)

Acknowledged:

ZYXWV Freight Company

____

President

____

Date

* Some accountants prefer not to obtain an acknowledgment, in which case their letter would omit the paragraph beginning "If the foregoing..."and the spaces for the acknowledgment. The first paragraph of their letter might begin as follows: "This letter sets forth our understanding of the terms and objectives of our engagement..."

.23 Illustrative Engagement Letter for Compilation of Personal Financial Statements

SWIFT, MARCH & COMPANY Certified Public Accountants

[Date]

Mr. John Henry
643 Spring Road
Nowhere, Anystate 00000

Dear Mr. Henry:

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

We will perform the following service(s):

1. We will compile, from information you provide, the statement of financial condition of James and Jane Person as of [*date*], and the related statement of changes in net worth for the [*period*] then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. We will not audit or review such financial statements. Our report on the financial statements is presently expected to read as follows:

   [*Standard Compilation Report*]

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

2. We will also [*discussion of other services, if any*].

Our engagement cannot be relied upon to disclose errors, irregularities, or illegal acts including fraud or defalcations, that might exist. However, we will inform you of any material errors that come to our attention and any irregularities or illegal acts that come to our attention, unless they are clearly inconsequential.

Our fees for these services [*specify fees or terms*].

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

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

Sincerely yours,

____

[*Signature of accountant*]

Acknowledged:

____

____

____

[*Date*]

[Source: AICPA *Personal Financial Statements Guide.*]

.24 Illustrative Engagement Letter for Review of Personal Financial Statements

SWIFT, MARCH & COMPANY Certified Public Accountants

[Date]

Mr. John Henry
643 Spring Road
Nowhere, Anystate 00000

Dear Mr. Henry:

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

We will perform the following service(s):

1. We will review the statement of financial condition of James and Jane Person as of [*date*], and the related statement of changes in net worth for the [*period*] then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Our review will consist primarily of inquiries of company personnel and analytical procedures applied to financial data and we will require a representation letter from management.

   A review does not contemplate obtaining an understanding of the internal control structure or assessing control risk, tests of accounting records and responses to inquiries by obtaining corroborating evidential matter, and certain other procedures ordinarily performed during an audit. Thus, a review does not provide assurance that we will become aware of all significant matters that would be disclosed in an audit. Our report on the financial statements is presently expected to read as follows:

   [*Standard Review Report*]

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

2. We will also [*discussion of other services, if any*].

Our engagement cannot be relied upon to disclose errors, irregularities, or illegal acts including fraud or defalcations, that might exist. However, we will inform you of any material errors that come to our attention and any irregularities or illegal acts that come to our attention, unless they are clearly inconsequential. We will not perform an audit of such financial statements, the objective of which is the expression of an opinion regarding the financial statements taken as a whole, and, accordingly, we will not express such an opinion on them.

Our fees for these services [*specify fees or terms*].

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

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

Sincerely yours,

____

[*Signature of accountant*]

Acknowledged:

____

____

____

[*Date*]

[Source: AICPA *Personal Financial Statements Guide.*]

[The next page is 2301.]

AAM Section 2300
Working Papers

Compilation Engagements

.01 SSARS 1 (AR section 100) does not address workpaper documentation for a compilation engagement. However, many accountants prefer compilation workpapers that include all necessary documentation to verify that compilation procedures were performed. In determining what workpapers the accountant will need, he or she should consider any peer review requirements that the firm will need to meet. AAM section 11,000 offers a discussion on compliance with the AICPA's quality control standards.

Compilation Procedures

.02 The following items are generally documented in a CPA's compilation workpapers:

- Documentation of the accountant's knowledge of the client's business and the accounting principles and practices of the industry in which the entity operates
- Documentation of the understanding with the client concerning the services to be rendered, usually in the form of an engagement letter
- Documentation that the accountant has read the compiled financial statements
- Support for a change in the level of service performed, if necessary
- Working trial balance
- Reasons for omitting substantially all disclosures
- Documentation of discussions of unusual items

.03 In addition, if the CPA prepares the financial statements as well as compiles them, he or she should also include in the workpapers the following:

- Support for information in the notes to the financial statements
- Copies of preliminary client records (e.g., working trial balance and adjustments) required to arrive at final compiled financial statements

Compilation Checklists

.04 Procedural checklists can serve as means of documenting in the workpapers that all the necessary procedures have been performed. When completing a procedural checklist, the accountant should refer to the specific workpaper documenting completion of the checklist step. An illustrative procedural checklist for a compilation can be found in AAM section 2300.14.

Review Engagements

.05 As noted in AAM section 2100, a review of financial statements involves performing inquiry and analytical procedures. SSARS 1, paragraph 30 (AR section 100.30), discusses workpaper documentation for review engagements. SSARS 1 (AR section 100) does not specify the form or content of the working papers in connection with a review engagement, but paragraph 30 does state that the working papers should describe the following:

a. The matters covered in the accountant's inquiry and analytical procedures

b. Unusual matters that the accountant considered during the performance of the review, including their disposition

Review Procedures—Inquiry

.06 SSARS 1, paragraph 27 (AR section 100.27), states that the accountant's inquiries should generally consist of the following:

a. Inquiries concerning the entity's accounting principles and practices and the methods followed in applying them.

b. Inquiries concerning the entity's procedures for recording, classifying, and summarizing transactions, and accumulating information for disclosure in the financial statements.

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

d. Inquiries of persons having responsibility for financial and accounting matters concerning (1) whether the financial statements have been prepared in conformity with generally accepted accounting principles consistently applied, (2) changes in the entity's business activities or accounting principles and practices, (3) matters as to which questions have arisen in the course of applying the foregoing procedures, and (4) events subsequent to the date of the financial statements that would have a material effect on the financial statements.

.07 SSARS 1, Appendix A (AR section 100.52), contains illustrative inquiries in connection with a review engagement. These illustrative inquiries appear in AAM section 2300.15. These inquiries do not necessarily apply to all engagements, nor are they meant to be all-inclusive.

Review Procedures—Analytical

.08 SSARS 1, paragraph 27c (AR section 100.27c), states that analytical procedures consist of the following:

1. Comparison of the financial statements with statements for a comparable prior period(s)

2. Comparison of the financial statements with anticipated results, if available

3. Study of the relationship of the elements of the financial statements that would be expected to conform to a predictable pattern based on the entity's experience

.09 Three common forms of analytical procedures are ratio analysis, trend analysis, and tests for reasonableness of data. Once the accountant performs his analytical procedures, he or she must evaluate the results, usually against past historical results or industry averages. Illustrative analytical procedures workpapers can be found in AAM section 2300.16 and .17.

.10 SSARS 1, paragraph 27 (AR section 100.27), also suggests that the following review procedures be performed:

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

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

.11 The following items are usually included in the workpapers for a review engagement:

- Documentation of the accountant's knowledge of the client's business and the accounting principles and practices of the industry in which it operates
- An engagement letter
- Support for a change in the level of service, if any
- Documentation of all inquiries and respective responses
- Documentation of all analytical procedures
- A representation letter
- Documentation of discussions of unusual matters
- Copies of reports of other accountants who have performed services with respect to a subsidiary or other significant investee

Representation Letters

.12 SSARS 7 amended SSARS 1 to require representation letters in all review engagements performed under SSARS. An illustrative representation letter for a review engagement can be found in AAM sections 2300.18 and 7400.02.

Review Checklists

.13 In the same way that procedural checklists are suggested for compilation engagements, it is wise to prepare such a checklist for a review engagement. An illustrative procedural checklist for a review engagement can be found in AAM section 2300.19.

.14 Short-Form Checklist for a Compilation Engagement

	AR Ref.*	Initials
1. Obtain an engagement letter or document an understanding of the engagement in a memorandum. (See section 3175.09 for a sample engagement memorandum.)	.08	______
2. Acquire the necessary knowledge of client's industry accounting principles and practices.	.10	______
3. Acquire a general understanding of the client's business transactions, the form of the accounting records, the stated qualifications of the accounting personnel, the accounting basis used, and the form and content of the financial statements. (It is not necessary to make inquiries or perform other procedures unless the information supplied is questionable.)	.11-.12	______
4. Read the financial statements and determine if they are appropriate in form and free from obvious material error.	.13	______
5. Consider whether all disclosures required by generally accepted accounting principles (GAAP) or an acceptable comprehensive basis of accounting are provided. If they are not, go to step 6. If they are, go to step 7.	.19	______
6. If substantially all disclosures required by GAAP or an other comprehensive basis of accounting are omitted, indicate this in a separate paragraph in your report; if a comprehensive basis of accounting other than GAAP is used, disclose this basis either in the financial statements or in your report. If the statement of cash flows is also omitted in GAAP statements, modify the scope paragraph and disclosure deficiency paragraph accordingly. If most, but not all, disclosures are omitted, notes to the financial statements should be labeled "Selected Information—Substantially All Disclosures Required by Generally Accepted Accounting Principles Are Not Included."	.19-.21	______
7. Consider whether the financial statements contain measurement departures from GAAP or other comprehensive basis of accounting. If they do, go to step 8. If they do not, go to step 9.	.39	______
8. Get client to revise the financial statements. Failing that, consider modifying your report by adding a separate paragraph or paragraphs. If the impact of the departure has been determined by management or is known by you, disclose the dollar effects in your report. (However, uncertainties and inconsistencies are not measurement departures if they are properly disclosed. See step 5.) Withdraw from the engagement if the GAAP departures are designed to mislead statement users.	.39-.40	______
9. Determine whether the firm is independent. If the firm is not, go to step 10. If the firm is, go to step 11.	.22	______
10. If the firm is not independent, add a separate paragraph to your report: "I am (we are) not independent with respect to XYZ Company."	.22	______
11. If the financial statements are accompanied by information presented for supplementary analysis purposes, include such other data in the compilation report.	.43	______
12. Mark each page of the financial statements, including any supplemental data, "See accountant's compilation report."	.16	______
13. Date your report using the date the compilation was completed.	.15	______
14. Issue the financial statements and related compilation report.	.14	______
15. If subsequent to the date of the report, facts that would possibly cause the financial statements to be misleading are discovered (and were in existence at the report date), consult SAS No. 1, section 561 (AU section 561), Interpretation No. 4 of SSARS No. 1 (AR section 9100.13—.15), and your attorney.	.42	______

Completed by ______________________________ Date: ______________

* The abbreviation "AR Ref." in this checklist means AR section 100. All references in this checklist are to paragraphs in AR section 100.

.15 Review of Financial Statements—Illustrative Inquiries

1. General

   a. What are the procedures for recording, classifying, and summarizing transactions (relates to each section discussed below)?

   b. Do the general ledger control accounts agree with subsidiary records (for example, receivables, inventories, investments, property and equipment, accounts payable, accrued expenses, non-current liabilities)?

   c. Have accounting principles been applied on a consistent basis?

2. Cash

   a. Have bank balances been reconciled with book balances?

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

   c. Has a proper cutoff of cash transactions been made?

   d. Are there any restrictions on the availability of cash balances?

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

3. Receivables

   a. Has an adequate allowance been made for doubtful accounts?

   b. Have receivables considered uncollectible been written off?

   c. If appropriate, has interest been reflected?

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

   e. Are there any receivables from employees and related parties?

   f. Are any receivables pledged, discounted, or factored?

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

4. Inventories

   a. Have inventories been physically counted? If not, how have inventories been determined?

   b. Have general ledger control accounts been adjusted to agree with physical inventories?

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

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

   e. What is the basis of valuation?

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

   g. Have write-downs for obsolescence or cost in excess of net realizable value been made?

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

   i. Are there any inventory encumbrances?

5. Prepaid Expenses
   a. What is the nature of the amounts included in prepaid expenses?
   b. How are these amounts amortized?
6. Investments, Including Loans, Mortgages, and Intercorporate Investments
   a. Have gains and losses on disposal been reflected?
   b. Has investment income been reflected?
   c. Has appropriate consideration been given to the classification of investments between current and noncurrent, and the difference between the cost and market value of investments?
   d. Have consolidation or equity accounting requirements been considered?
   e. What is the basis of valuation of marketable equity securities?
   f. Are investments unencumbered?
7. Property and Equipment
   a. Have gains or losses on disposal of property or equipment been reflected?
   b. What are the criteria for capitalization of property and equipment? Have such criteria been applied during the fiscal period?
   c. Does the repairs and maintenance account only include items of an expense nature?
   d. Are property and equipment stated at cost?
   e. What are the depreciation methods and rates? Are they appropriate and consistent?
   f. Are there any unrecorded additions, retirements, abandonments, sales, or trade-ins?
   g. Does the entity have material lease agreements? Have they been properly reflected?
   h. Is any property or equipment mortgaged or otherwise encumbered?
8. Other Assets
   a. What is the nature of the amounts included in other assets?
   b. Do these assets represent costs that will benefit future periods? What is the amortization policy? Is it appropriate?
   c. Have other assets been properly classified between current and noncurrent?
   d. Are any of these assets mortgaged or otherwise encumbered?
9. Accounts and Notes Payable and Accrued Liabilities
   a. Have all significant payables been reflected?
   b. Are all bank and other short-term liabilities properly classified?
   c. Have all significant accruals, such as payroll, interest, and provisions for pension and profit-sharing plans been reflected?
   d. Are there any collateralized liabilities?
   e. Are there any payables to employees and related parties?

10. Long-Term Liabilities

    a. What are the terms and other provisions of long-term liability agreements?

    b. Have liabilities been properly classified between current and non-current?

    c. Has interest expense been reflected?

    d. Has there been compliance with restrictive covenants of loan agreements?

    e. Are any long-term liabilities collateralized or subordinated?

11. Income and Other Taxes

    a. Has provision been made for current and prior-year federal income taxes payable?

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

    c. Are there temporary differences? If so, have deferred taxes been reflected?

    d. Has provision been made for state and local income, franchise, sales, and other taxes payable?

12. Other Liabilities, Contingencies, and Commitments

    a. What is the nature of the amounts included in other liabilities?

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

    c. Are there any contingent liabilities, such as discounted notes, drafts, endorsements, warranties, litigation, and unsettled asserted claims? Are there any unasserted potential claims?

    d. Are there any material contractual obligations for construction or purchase of real property and equipment and any commitments or options to purchase or sell company securities?

13. Equity

    a. What is the nature of any changes in equity accounts?

    b. What classes of capital stock have been authorized?

    c. What is the par or stated value of the various classes of stock?

    d. Do amounts of outstanding shares of capital stock agree with subsidiary records?

    e. Have capital stock preferences, if any, been disclosed?

    f. Have stock options been granted?

    g. Has the entity made any acquisitions of its own capital stock?

    h. Are there any restrictions on retained earnings or other capital?

14. Revenue and Expenses

    a. Are revenues from the sale of major products and services recognized in the appropriate period?

    b. Are purchases and expenses recognized in the appropriate period and properly classified?

    c. Do the financial statements include discontinued operations or items that might be considered extraordinary?

15. Other

a. Are there any events that occurred after the end of the fiscal period that have a significant effect on the financial statements?

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

c. Have there been any material transactions between related parties?

d. Are there any material uncertainties? Is there any change in the status of material uncertainties previously disclosed?

.16 Illustrative Ratio Analysis Worksheet

Below you will find 34 financial ratios. These financial ratios include all of the key ratios included in Robert Morris Associates Annual Statement Studies [Published by Robert Morris Associates, Philadelphia, PA] and Dun and Bradstreet's Key Business Ratios [Published by Dun and Bradstreet Credit Services, Murray Hill, NJ].

	Ratio Name		Formula for Ratio		Calculations
1.	Current Ratio	=	Current Assets / Current Liabilities	=	
2.	Quick Ratio	=	Quick Assets / Current Liabilities	=	
3.	Days Sales in Accounts Receivable	=	Accounts Receivable (net) / Net Sales/360	=	
4.	Allowance for Bad Debts as a % of A/R	=	Allowance for Bad Debts / Accounts Receivable	=	
5.	Bad Debt Exp. as a Percentage of Net Sales	=	Bad Debt Expense / Net Sales	=	
6.	Inventory Turnover	=	Cost of Sales × (Days/Year) / Inventory × (Days/Period)	=	
7.	Net Sales to Inventory	=	Net Sales × (Days/Year) / Inventory × (Days/Period)	=	
8.	Days Inventory	=	Inventory × (Days/Period) / Cost of Sales	=	
9.	Net Fixed Assets to Net Worth	=	Net Fixed Assets / Net Worth	=	
10.	Current Liabilities to Net Worth	=	Current Liabilities / Net Worth	=	
11.	Current Liabilities to Inventory	=	Current Liabilities / Inventory	=	
12.	Accounts Payable to Net Sales	=	Accts. Payable × (Days/Period) / Net Sales × (Days/Year)	=	
13.	Total Liabilities to Net Worth	=	Total Liabilities / Net Worth	=	

	Ratio Name		Formula for Ratio		Calculations
14.	Net Worth to Total Liabilities	=	$\frac{\text{Net Worth}}{\text{Total Liabilities}}$	=	
15.	Net Sales to Working Capital	=	$\frac{\text{Net Sales} \times \text{(Days/Year)}}{\text{Working Capital} \times \text{(Days/Per.)}}$	=	
16.	Total Assets to Net Sales	=	$\frac{\text{Total Assets} \times \text{(Days/Period)}}{\text{Net Sales} \times \text{(Days/Year)}}$	=	
17.	Return on Total Assets	=	$\frac{\text{Net Income} \times \text{(Days/Year)}}{\text{Total Assets} \times \text{(Days/Period)}}$	=	
18.	Return on Net Worth	=	$\frac{\text{Net Income} \times \text{(Days/Year)}}{\text{Net Worth} \times \text{(Days/Period)}}$	=	
19.	Return on Net Sales	=	$\frac{\text{Net Income}}{\text{Net Sales}}$	=	
20.	Net Sales to Accounts Receivable	=	$\frac{\text{Net Sales} \times \text{(Days/Year)}}{\text{A/R (net)} \times \text{(Days/Period)}}$	=	
21.	Net Sales to Net Fixed Assets	=	$\frac{\text{Net Sales} \times \text{(Days/Year)}}{\text{Fixed Assets} \times \text{(Days/Period)}}$	=	
22.	Net Sales to Total Assets	=	$\frac{\text{Net Sales} \times \text{(Days/Year)}}{\text{Total Assets} \times \text{(Days/Period)}}$	=	
23.	Net Sales to Net Worth	=	$\frac{\text{Net Sales} \times \text{(Days/Year)}}{\text{Net Worth} \times \text{(Days/Period)}}$	=	
24.	Days Payables in Cost of Sales	=	$\frac{\text{Accts. Payable} \times \text{(Days/Period)}}{\text{Cost of Sales}}$	=	
25.	Income Before Tax to Net Worth	=	$\frac{\text{Inc. Before Tax} \times \text{(Days/Year)}}{\text{Net Worth} \times \text{(Days/Period)}}$	=	
26.	Income Before Tax to Total Assets	=	$\frac{\text{Inc. Before Tax} \times \text{(Days/Year)}}{\text{Total Assets} \times \text{(Days/Period)}}$	=	
27.	Retained Earnings to Net Income	=	$\frac{\text{Ret. Earn.} \times \text{(Days/Period)}}{\text{Net Income} \times \text{(Days/Year)}}$	=	
28.	Gross Profit Percentage	=	$\frac{\text{Net Sales} - \text{Cost of Sales}}{\text{Net Sales}}$	=	
29.	Operating Expenses as a % of Net Sales	=	$\frac{\text{Operating Expenses}}{\text{Net Sales}}$	=	

	Ratio Name		Formula for Ratio		Calculations
30.	Times Interest Earned	=	Inc. Before Interest and Taxes / Interest Expense	=	
31.	Interest Expenses to Net Sales	=	Interest Expense / Net Sales	=	
32.	Amort/Deprec Expense to Net Sales	=	Amort. and Deprec. Expense / Net Sales	=	
33.	Officers Compensation to Net Sales	=	Officers Compensation / Net Sales	=	
34.	Altman Z Score	=	The Altman Z Score, developed by Edward I. Altman, is a composite formula that is widely used to measure the financial "health" of a company. The formula takes financial ratios and multiplies each by a specific constant. The amounts so computed are added together to obtain an overall score. This score is then compared to scores from other companies to rate relative financial health. The formulas are as follows:		

For private companies: (four variable)

Working Capital / Total Assets	×	6.56	=	
Retained Earnings / Total Assets	×	3.26	=	
Income Before Interest and Taxes / Total Assets	×	6.72	=	
Net Worth / Total Liabilities	×	1.05	=	
		Altman Z Score		

For private companies:
(five variable)

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

For public companies:

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

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

.17 Illustrative Analytical Procedures Comparative Report

Sample Services, Inc.

Analytical Procedures Comparative Report
For the period ended December 31, 19XX

Prepared by ______
Reviewed by ______

Account Name	Account #	Prior	Ending	Net Change	%
Cash—Operating	110				
Cash—Savings	115				
Petty Cash	118				
Accounts Receivable	120				
Prepaid Insurance	130				
Prepaid Dues	131				
Prepaid Interest	132				
Supplies Inventory	140				
Land	200				
Buildings	210				
Accum. Depr.—Buildings	215				
Equipment	220				
Accum. Depr.—Equipment	225				
Other Assets	250				
Notes Payable	310				
Accounts Payable	330				
Accrued Liabilities	340				
Long-term Debt	390				
Common Stock	400				
Paid-in Capital	410				
Retained Earnings	450				
Sales	510				
Interest Income	520				
Other Revenue	530				
Automobile	700				
Bad Debts	705				
Depreciation	710				
Donations	715				
Insurance	720				
Interest	725				
Licenses & Dues	730				
Medical Insurance	735				
Payroll Taxes	740				
Postage	745				
Professional Fees	750				
Profit Sharing	755				
Repairs & Maintenance	760				
Salaries—Employees	765				
Salaries—Officers	767				
Supplies	770				
Telephone	775				
Travel	780				
Utilities	785				
Miscellaneous	790				
	Net Balance				

.18 Review of Financial Statements—Illustrative Representation Letter

(Date of Accountant's Report)

(To the Accountant)

In connection with your review of the (identification of financial statements) of (name of client) as of (date) and for the (period of review) for the purpose of expressing limited assurance that there are no material modifications that should be made to the statements in order for them to be in conformity with generally accepted accounting principles, we confirm, to the best of our knowledge and belief, the following representations made to you during your review.

1. The financial statements referred to above present the financial position, results of operations, and cash flows of (name of client) in conformity with generally accepted accounting principles. In that connection, we specifically confirm that—

    a. The company's accounting principles, and the practices and methods followed in applying them, are as disclosed in the financial statements.

    b. There have been no changes during the (period reviewed) in the company's accounting principles and practices.

    c. We have no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.

    d. There are no material transactions that have not been properly reflected in the financial statements.

    e. There are no material losses (such as from obsolete inventory or purchase or sales commitments) that have not been properly accrued or disclosed in the financial statements.

    f. There are no violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency, and there are no other material liabilities or gain or loss contingencies that are required to be accrued or disclosed.

    g. The company has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged.

    h. There are no related party transactions or related amounts receivable or payable that have not been properly disclosed in the financial statements.

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

    j. No events have occurred subsequent to the balance sheet date that would require adjustment to, or disclosure in, the financial statements.

2. We have advised you of all actions taken at meetings of stockholders, board of directors, and committees of the board of directors (or other similar bodies, as applicable) that may affect the financial statements.

3. We have responded fully to all inquiries made to us by you during your review.

____
(Name of Owner or Chief
Executive
Officer and Title)

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

.19 Short-Form Checklist for a Review Engagement

	AR Ref*	Initials
1. Obtain an engagement letter or document an understanding of the engagement in a memorandum. (See section 3175.09 for a sample engagement memorandum.)	.08*	______
2. Determine whether your firm is independent, if the firm is not, go to step 3. If the firm is, go to step 4.	.38	______
3. Stop. Do not issue a review report. (However, it may be possible to issue a compilation report.)	.38	______
4. Acquire the necessary knowledge of the client's industry accounting principles and practices.	.24	______
5. Acquire a general understanding of the nature of the client's business, including (a) its operating characteristics and (b) the nature of its assets, liabilities, revenues, and expenses.	.26	______
6. Apply appropriate inquiry and analytical procedures in order to obtain a reasonable basis for expressing limited assurance that there are no material modifications that should be made to the financial statements.	.24 & .27	______
7. Read the financial statements to determine whether, based on the information presented, they appear to conform to generally accepted accounting principles (GAAP) or an other comprehensive basis of accounting. Obtain reports of other accountants for subsidiaries, investee, etc., if any. Indicate division of responsibility if reference is made to other accountants.	.27	______
8. Perform additional procedures if information appears to be incorrect, incomplete, or otherwise unsatisfactory.	.30	______
9. Document in your workpapers matters covered in steps 6 and 7 above. Also describe unusual matters that were considered and how they were resolved (step 8).	.31	______
10. Determine whether the inquiry and analytical procedures considered necessary to achieve limited assurance are incomplete or restricted in any way. If they are, go to step 11; if not, go to step 12.	.36	______
11. Consider whether a compilation report should be issued rather than a review report. (A review that is incomplete or restricted is not an adequate basis for issuing a review report.) If the client has refused to provide additional or revised information, the accountant should withdraw from the engagement.	.12 & .36	______
12. Consider whether the financial statements contain known departures from GAAP or an other comprehensive basis of accounting, including disclosure departures. If they do, go to step 13. If they do not, go to step 14.	.39	______
13. Get client to revise the financial statements. Failing that, consider modifying your report by adding a separate paragraph or paragraphs. If the impact of the departure has been determined by management or is known by you, disclose the dollar effects in your report. (However, uncertainties and inconsistencies should not cause the report to be modified if they are properly disclosed.) Withdraw from the engagement if the departures are designed to mislead financial statement users.	.39 & .40	______
14. Obtain a representation letter from the client.	.28	______
15. Determine whether the basic financial statements are accompanied by information presented for supplementary analysis purposes. If they are, go to step 16. If they are not, go to step 17.	.43	______
16. Indicate the responsibility assumed for the supplementary information in your review report or in a separate report. The report should disclose whether (a) the supplemental information has been reviewed (as part of the basic financial statement review) and you are not aware of any needed material modification or (b) the supplemental information has not been reviewed but only compiled.	.43	______

* The abbreviation "AR Ref." in this checklist means AR section 100. All references in this checklist are to paragraphs in AR section 100.

	AR Ref*	Initials
17. Mark each page of the financial statements, including any supplemental data, "See accountant's review report."	.34	______
18. Date your report using the date the inquiry and analytical procedures were completed.	.33	______
19. Issue the financial statements and related review report.	.32	______
20. If subsequent to the date of the report, facts that would possibly cause the financial statements to be misleading are discovered (and were in existence at the report date), consult SAS No. 1, section 561 (AU section 561), Interpretation No. 4 of SSARS No. 1 (AR section 9100.13—.15), and your attorney.	.42*	______

Completed by ______________________ Date: ____

[The next page is 2401.]

* The abbreviation "AR Ref." in this checklist means AR section 100. All references in this checklist are to paragraphs in AR section 100.

AAM Section 2400
Form and Content of Financial Statements

Statements Prepared

.01 The basic financial statements for a company that presents its financial statements in accordance with generally accepted accounting principles (GAAP) are:

- Balance Sheet
- Income Statement
- Statement of Cash Flows (either direct or indirect method)
- Statement of Changes in Stockholders' Equity

Examples of financial statement presentations can be found in the AICPA Disclosure Checklist Series.

.02 The description of accounting policies and the notes to the financial statements are considered part of the basic financial statements.

.03 Each financial statement presented should include the name of the company, the applicable statement title, and the date or time period covered. SSARS 1, paragraph 16 (AR section 100.16), states that each page of financial statements compiled by the accountant should contain a reference such as "See Accountant's Compilation Report." Each page of reviewed financial statements should refer to the accountant's review report, as required by SSARS 1, paragraph 34 (AR section 100.34).

.04 When the financial statements are either compiled or reviewed, some accountants prefer to follow the statement title with the word "unaudited." SSARS 1 (AR section 100) does not require use of the word "unaudited" when associated with compiled or reviewed statements nor does it prohibit its use.

Comparative Financial Statements

.05 There is no requirement to prepare comparative financial statements. However, Accounting Research Bulletin (ARB) No. 43, *Restatement and Revision of Accounting Research Bulletins,* chapter 2, paragraph 1, states that comparative statements in annual and other reports enhance the usefulness of such reports. ARB No. 43 also states that notes of the prior year should be repeated, or referred to, to the extent that they continue to be of significance.

.06 When comparative financial statements are presented, the accountant should issue an appropriate report for each period presented in accordance with SSARS 2 (AR section 200). Comparative financial statements may contain statements for which the level of service provided in each period is different. Often, times the level of service is indicated in the statement title as follows:

ABC COMPANY

BALANCE SHEETS

As of December 31, 19X2 (Reviewed) and 19X1 (Compiled)

.07 Illustrative reports on comparative financial statements can be found in AAM sections 10,400.12—.17 and 10,500.07—.12.

Notes to Financial Statements

.08 The notes to the financial statements, as a part of the basic statements, are the responsibility of management. The accountant should explain the statements and the notes to the client so that the client understands the statements in sufficient depth to take full responsibility for them. The practitioner who assists the client in preparing the financial statements or who totally prepares them must be careful in the wording of the notes. The accountant should avoid wording the notes in such a way as would imply that they are the responsibility of the accountant. For example, words such as "we," "our," and "the client," should be avoided. When referring to the client, some accountants prefer to use the terms "the Company" or "Management."

.09 All of the disclosures required by GAAP should be made either on the face of the financial statements or in the notes thereto. In a compilation engagement, the client may elect to omit substantially all disclosures; a more detailed discussion of this appears in AAM section 2500. For a list of required disclosures, the accountant and the client may wish to review the applicable AICPA disclosure checklists.

Supplementary Information

.10 The accountant's report on supplementary information is discussed in SSARS 1, paragraph 43 (AR section 100.43), which states that when the basic financial statements are accompanied by information presented for supplementary analysis purposes, the accountant should clearly indicate the degree of responsibility he is taking regarding the other information. The supplementary information is generally separated from the basic financial statements and many accountants believe it should be presented after the basic statements.

.11 When the accountant compiles both the basic financial statements and the other data presented for supplementary analysis purposes only, his or her compilation report should include the supplementary information.

.12 When the accountant has reviewed the basic financial statements, he may indicate the degree of responsibility he is taking with respect to the other information by an explanation in his review report or in a separate report on the other data, that the review has been made for the purpose of expressing limited assurance that there are no material modifications that should be made to the financial statements for them to be in conformity with GAAP, and either—

a. The other data accompanying the financial statements are presented for supplementary analysis purposes only and have been subjected to the inquiry and analytical procedures applied in the review of the financial statements, and the accountant did not become aware of any material modifications that should be made to such data, or

b. The other data accompanying the financial statements are presented for supplementary analysis purposes and have not been subjected to the inquiry and analytical procedures applied in the review of the financial statements, but were compiled from information that is the representation of management, without audit or review, and the accountant does not express an opinion or any other form of assurance on such data.

.13 Illustrative accountants' reports on supplementary information accompanying compiled and reviewed financial statements can be found in AAM sections 10,400.18 and 10,500.13—.14, respectively.

Subsequent Discovery of Facts

.14 Subsequent to the report date for compiled or reviewed financial statements the accountant may become aware of facts that may have existed at the report date which might have caused the accountant to believe that information supplied by the client was incorrect, incomplete, or otherwise unsatisfactory. SSARS 1, paragraph 42 (AR section 100.42), states that, in those circumstances, the accountant may wish to consider the guidance in SAS No. 1, section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* (AU section 561), in determining the proper course of action.

.15 Interpretation 4 of SSARS 1, "Discovery of Information After the Date of the Accountant's Report" (AR section 9100.13—.15), discusses two factors the accountant might consider when determining the appropriate course of action regarding the subsequent discovery. The two factors discussed are (1) the reliability of the information and (2) the existence of persons known to be relying on or likely to rely on the financial statements. If the accountant determines that the information is reliable and there are persons known to be relying on or likely to rely on the information, the accountant would ordinarily conclude that those individuals should be notified in an appropriate manner.

.16 Both SSARS 1, paragraph 42 (AR section 100.42) and Interpretation 4 (AR section 9100.13—.15) indicate that because of the legal implications involved in actions contemplated under SAS No. 1, section 561 (AU section 561), and Interpretation 4 discussed in paragraphs .14 and .15, the accountant should consider consulting an attorney.

[The next page is 2501.]

AAM Section 2500
Accountant's Reports

.01 The users of financial statements should be able to easily identify the degree of responsibility that an accountant is taking with respect to a specific set of financial statements. The usual method of conveying the amount of responsibility taken is the written accountant's report. Therefore, whenever an accountant reviews or compiles financial statements, a report prepared in accordance with the AICPA Statements on Standards for Accounting and Review Services.

.02 According to SSARS 1, paragraph 6 (AR section 100.06), an accountant should not consent to the use of his or her name in a document or written communication containing unaudited financial statements unless

a. the accountant has compiled or reviewed the financial statements and his (her) report accompanies them, or

b. the financial statements are accompanied by an indication that the accountant has not compiled or reviewed the financial statements and that no responsibility is assumed for them.

.03 If an accountant becomes aware that his or her name has been improperly used in a client-prepared document containing unaudited financial statements, the client should be advised that use of his or her name is inappropriate. The accountant should consider what other courses of action need to be taken, including consulting with his or her attorney.

.04 An accountant should not submit unaudited financial statements to his or her client or third parties unless, as a minimum service, the financial statements have been compiled in accordance with Statements on Standards for Accounting and Review Services.

.05 Submission of financial statements under SSARS is defined as presenting to a client or others financial statements that the accountant has—

a. Generated, either manually or through the use of computer software, or

b. Modified by materially changing account classification, amounts, or disclosures directly on client-prepared financial statements.

.06 If the accountant has performed more than one service, the report issued should be appropriate for the highest level of service performed. For example, if an accountant performs both a compilation and an audit of financial statements, the appropriate report to issue would be the audit report.

Compilation Report

.07 SSARS 1, paragraph 14 (AR section 100.14), states that financial statements compiled by an accountant should be accompanied by a report that states—

a. A compilation has been performed in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

b. A compilation is limited to presenting in the form of financial statements information that is the representation of management.

c. The financial statements have not been audited or reviewed and, accordingly, the accountant does not express an opinion or any other form of assurance on them.

Any other procedures performed by the accountant either before or during the compilation engagement should not be described in the accountant's report. An example of the accountant's standard compilation report can be found in AAM section 10,400.01.

.08 Each page of the financial statements compiled by the accountant should include a reference to the accountant's report, such as, "See Accountant's Compilation Report."

.09 The date of the completion of the compilation procedures should be used as the date of the accountant's report.

.10 An accountant may be asked to issue a compilation report on only one financial statement and not on the other related financial statements, for example, reporting on the balance sheet, but not on the related statements of income, retained earnings, and cash flows. SSARS 1 (AR section 100) does not prohibit the accountant from performing such a service.

.11 If an accountant is not independent, a compilation report may still be issued, provided that the accountant has followed the appropriate authoritative literature during his engagement. The accountant should disclose the lack of independence; however, the reason should not be described. The following statement should be included as the last paragraph of the report:

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

Review Report

.12 SSARS 1, paragraph 32 (AR section 100.32), states that financial statements reviewed by an accountant should be accompanied by a report that states—

a. A review has been performed in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

b. All information included in the financial statements is the representation of management of the entity.

c. A review consists principally of inquiries of company personnel and analytical procedures applied to financial data.

d. A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements taken as a whole and, accordingly, no such opinion is expressed.

e. The accountant is not aware of any material modifications that should be made to the financial statements in order for them to be in conformity with generally accepted accounting principles (GAAP), other than those modifications, if any, indicated in the report.

Any other procedures performed by the accountant either before or during the review engagement should not be described in the accountant's report. An example of the accountant's standard review report can be found in AAM section 10,500.01.

.13 Each page of the financial statements reviewed by the accountant should include a reference to the accountant's report, such as, "See Accountant's Review Report."

.14 The date of the completion of the accountant's inquiry and analytical procedures should be used as the date of the accountant's report.

.15 If an accountant is unable to perform the necessary inquiry and analytical procedures to achieve the limited assurance which is contemplated by a review, or the client does not provide the accountant with a representation letter, then the review is incomplete. Therefore, he or she would not have an adequate basis for issuing a review report. If this is the case, the accountant should consider whether in this situation the incomplete review also precludes the issuance of a compilation report on the financial statements. A change in the level of service is discussed in AAM section 2200.08 through .15.

.16 An accountant may be asked to issue a review report on only one financial statement and not on the other related financial statements, for example, reporting on the balance sheet, but not on the related statements of income, retained earnings, and cash flows. According to SSARS 1, paragraph 37 (AR section 100.37), the accountant may do so as long as the scope of the analytical procedures has not been limited.

.17 SSARS 1, paragraph 38 (AR section 100.38), precludes the accountant from issuing a review report for an entity with respect to which the accountant is not independent.

Modifications to Standard Report

Omission of Substantially All Disclosures

.18 SSARS 1, paragraphs 19 through 21 (AR section 100.19—.21), discuss reporting on financial statements that omit substantially all disclosures. An accountant may compile financial statements that omit substantially all disclosures required by GAAP, provided that this omission is clearly indicated in the report, and is not, to the accountant's knowledge, undertaken with the intention to mislead users of the financial statements. Examples of the appropriate reports under these circumstances can be found in AAM section 10,400.02—.03.

.19 If the entity wants to include disclosures about only a few matters in the form of notes to the financial statements, then that information should be clearly labeled as selected information, i.e., "Selected Information—Substantially All Disclosures Required by Generally Accepted Accounting Principles Are Not Included."

.20 If the financial statements are compiled in accordance with a comprehensive basis of accounting other than GAAP and disclosure is not made of the basis used, then the basis should be disclosed in the accountant's report.

Omission of Statement of Cash Flows

.21 FASB Statement No. 95, *Statement of Cash Flows,* paragraph 3, requires that an entity that provides a set of financial statements that reports both financial position and results of operations should include a statement of cash flows for each period for which results of operations are reported. Therefore, omitting this statement is a departure from GAAP. A GAAP departure must be disclosed in a separate paragraph of the accountant's report. If the statement of cash flows is omitted, then the following paragraph should be added to the accountant's compilation or review report:

> A statement of cash flows for the year ended December 31, 19XX, 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 operation.

The first paragraph of the report should also be modified accordingly. Examples of the full accountant's reports, both compilation and review, can be found in AAM sections 10,300.01 and 10,400.01, respectively.

GAAP Departures

.22 An accountant who is engaged to compile or review financial statements may become aware of a GAAP departure is material to the financial statements taken as a whole. The accountant should ask management to revise the financial statements. If management refuses to revise the financial statements, then the accountant should consider whether modification of the standard report is sufficient to disclose the departure.

.23 SSARS 1, paragraph 40 (AR section 100.40), states that if the accountant decides that modification of the standard report is appropriate, then the departure should be disclosed in a separate paragraph of the report. This disclosure should include the effects of the departure on the financial statements if management has determined these effects or if the accountant has been able to determine the effects through other procedures performed during the engagement. The accountant is not required to determine the effects if management has not done so provided the accountant states in his report that such determination has not been made. Examples of both compilation and review reports can be found in AAM sections 10,400.05—.06 and 10,500.02—.04, respectively.

.24 If the accountant believes that modification of the standard compilation or review report is not sufficient to indicate the deficiencies of the financial statements taken as a whole, then according to SSARS 1, paragraph 41 (AR section 100.41), the accountant should withdraw from the engagement and provide no further services with respect to that set of financial statements. The accountant may also want to contact his or her attorney.

Scope Limitations

.25 According to SSARS 1, paragraph 36 (AR section 100.36), if an accountant is unable to perform the necessary inquiry and analytical procedures to achieve the limited assurance contemplated by a review or the client does not provide the accountant with a representation letter then the review is incomplete and the accountant would not have an adequate basis for issuing a review report. If this is the case, then the accountant should consider whether the incomplete review also precludes issuing a compilation report on the financial statements.

.26 In such a situation, the accountant should consider the matters discussed in SSARS 1, paragraphs 44—49 (AR section 100.44—.49), in deciding whether it is appropriate to issue a compilation report on the financial statements.

Uncertainties

.27 Interpretation No. 11 of SSARS 1, "Reporting on Uncertainties" (AR section 9100.33—.40), offers guidance on the accountant's reporting obligations when there is an uncertainty in the financial statements. Disclosure guidelines for uncertainties can be found in FASB Statement No. 5, *Accounting for Contingencies* (AC C59), and FASB Statement No. 47, *Disclosure of Long-Term Obligations* (AC C32).

.28 In evaluating the adequacy of disclosure of going-concern uncertainties, the accountant should look to the guidance provided in SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern,* paragraphs 10 and 11 (AU section 341.10—.11).

.29 If the accountant concludes that modification of the standard report is appropriate, the departure should be disclosed in a separate paragraph of the report, including disclosure of the effects of the departure on the financial statements if such effects have been determined by management or are known as the result of the accountant's procedures.

.30 Normally neither an uncertainty, including an uncertainty about an entity's ability to continue as a going concern, nor an inconsistency in the application of accounting principles would cause an accountant to modify the standard report provided the financial statements appropriately disclose such matters.

.31 Although it is not required, an accountant may wish to add an explanatory paragraph to the compilation or review report to emphasize the existence of an uncertainty. An example of an explanatory paragraph follows:

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

Examples of full compilation and review reports for this situation can be found in AAM sections 10,400.21 and 10,500.15, respectively.

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AAM Section 2600
Special Areas

Prescribed Forms

.01 SSARS 3 (AR section 300) allows an accountant to issue a compilation report on a prescribed form that calls for a departure from GAAP by using a measurement principle different from GAAP or by not requiring the disclosures required by GAAP. A prescribed form is defined in SSARS 3, paragraph 2 (AR section 300.02), as "any standard preprinted form designed or adopted by a body to which it is to be submitted, for example, forms used by industry trade associations, credit agencies, banks, and governmental and regulatory bodies other than those concerned with the sale or trading of securities."

.02 Generally, it is assumed that the information required by a prescribed form meets the needs of the body that required the form to be completed, and, therefore, it is not necessary for that body to be advised of departures from GAAP that are required by the form. An example of the compilation report to be issued when the unaudited financial statements of a nonpublic entity are included in a prescribed form that calls for departures from GAAP can be found in AAM section 10,400.19.

.03 If, during the compilation engagement, the accountant becomes aware of a departure from GAAP not required by the prescribed form, he should follow the guidance discussed in AAM section 2500.21 through .23 on GAAP departures. If the accountant finds that there is a departure from the requirements of the prescribed form, he or she should consider the departure to be the same as a departure from GAAP in determining the effects on the report. An example of a compilation report for a departure from GAAP which was not called for by the prescribed form can be found in AAM section 10,400.20.

.04 SSARS 3, paragraph 5 (AR section 300.05), states that if the accountant is asked to sign a preprinted form that does not conform with the guidance found in SSARS 3 (AR section 300) or SSARS 1 (AR section 100), he or she should not sign the form, but should add the appropriate report to the prescribed form.

.05 If your client applies for a bank loan, the bank loan officer may request financial statements in the format prescribed in the Robert Morris Associates' Business Credit Information Package (BCIP). Those financial statements are required to be in conformity with generally accepted accounting principles, however, they do not contain all disclosures required in complete GAAP presentations. AAM section 10,400.26 contains a sample prescribed-form compilation report for a BCIP presentation.

Specified Elements

.06 SSARS 1 (AR section 100) provides guidance on the compilation and review of financial statements. Some accountants are asked to issue review reports on separate presentations of specified elements, accounts or items of financial statements. Because this type of presentation is not a financial statement, guidance for this type of engagement is not found in the Statements on Standards for Accounting and Review Services. This type of engagement should follow the Attestation Standards. (See AAM section 10,500.18 for an illustrative review report.) If the accountant is engaged to apply agreed-upon procedures to elements, accounts, or items of a financial statement, he or she should refer to SAS No. 35, *Special Reports—Applying Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement* (AU section 622).

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AAM Section 3000

ENGAGEMENT PLANNING AND ADMINISTRATION

Sections 3165, 3170, and 3175 include illustrative audit assignment control forms, engagement letters, and an illustrative planning checklist that can be used by an accountant in the planning phase of an audit engagement.

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

Illustrative formats of audit assignment controls, engagement letters, and planning checklists are often helpful in developing a consistent style within a firm. However, no set of illustrative formats can cover all the situations that are likely to be encountered in practice because the circumstances of engagements vary widely.

Readers should consider other sources of illustrative presentations, such as those in authoritative pronouncements and AICPA audit and accounting guides.

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AAM Section 3100
Planning the Engagement

.01 The planning phase is an important part of every engagement. During this phase, the partner and the staff review the client's business and the industry in which the client operates, then develop an overall strategy for the expected conduct and scope of the engagement.

.02 The need for planning is highlighted in Rule 201, General Standards (ET section 201.01), AICPA Code of Professional Conduct, which states: "A member shall adequately plan and supervise an engagement."

.03 The first standard of fieldwork of generally accepted auditing standards states: "The work is to be adequately planned and assistants, if any, are to be properly supervised." Statement on Auditing Standards (SAS) No. 22, *Planning and Supervision* (AU section 311), provides authoritative interpretive guidance on the first standard of fieldwork.

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

.05 The planning memo and the planning checklist are two commonly used planning documents. The style and complexity of these documents will depend on engagement needs and firm preference. The same memo or checklist may be referred to in the review process to ensure that the items highlighted in the planning phase are given adequate attention during the engagement.

.06 The steps in audit planning are as follows:

a. Understand the scope of services and the nature of reports expected to be rendered.

b. Decide whether or not to accept the engagement.

c. Assign personnel to the engagement and prepare a preliminary time budget.

d. Assess independence of firm and audit team.

e. Understand the entity's business and the industry in which it operates.

f. Assess the auditability of the entity by—

1. Gaining an adequate understanding of the internal control structure.
2. Evaluating management integrity.

g. Establish an agreement with the client, preferably with an engagement letter.

h. Assess control risks.

i. Make a preliminary judgment about materiality levels for audit purposes.

j. Estimate the level of audit risk and consider its interactive components.

k. Consider how components of audit risk relate to one another for each cycle or major account.

l. Consider cost-effectiveness of different audit strategies.

m. Write the audit program and finalize a time budget.

[The next page is 3121.]

AAM Section 3105
Understanding the Assignment

.01 The auditor should (*a*) meet with the client to understand the type, scope, and timing of the engagement; (*b*) understand if reports on compliance, internal control structure, or segments of the entity are required; (*c*) understand the client's expectations, both stated and implied; and (*d*) review the expectations of both the owners and managers. A sample checklist is located in AAM section 3165.

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

.03 Statement on Auditing Standards (SAS) No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report,* sets forth the GAAP hierarchy. Statement on Standards for Accounting and Review Services 7 *Omnibus Statement on Standards for Accounting and Review Services—1992,* indicates that the GAAP hierarchy set forth in SAS No. 69 also applies to compilation and review engagements.

.04 SAS No. 69:

a. Presents two separate but parallel hierarchies—one for state and local governments and another for nongovernmental entities, and

b. Establishes a true GAAP hierarchy—each successive category in the hierarchy is a different level of authority.

.05 The table below summarizes the pronouncements that are included in each of the five categories of GAAP for nongovernmental entities and for state and local governments.

.06 GAAP Hierarchy Summary *

	Nongovernmental Entities	State and Local Governments
Established Accounting Principles	10a. FASB Statements and Interpretations, APB Opinions, and AICPA Accounting Research Bulletins	12a. GASB Statements and Interpretations, plus AICPA and FASB pronouncements if made applicable to state and local governments by a GASB Statement or Interpretation
	10b. FASB Technical Bulletins, AICPA Industry Audit and Accounting Guides, and AICPA Statements of Position	12b. GASB Technical Bulletins, and the following pronouncements if specifically made applicable to state and local governments by the AICPA: AICPA Industry Audit and Accounting Guides and AICPA Statements of Position
	10c. Consensus positions of the FASB Emerging Issues Task Force and AICPA Practice Bulletins	12c. Consensus positions of the GASB Emerging Issues Task Force ‡ and AICPA Practice Bulletins if specifically made applicable to state and local governments by the AICPA
	10d. AICPA accounting interpretations, "Qs and As" published by the FASB staff, as well as industry practices widely recognized and prevalent	12d. "Qs and As" published by the GASB staff, as well as industry practices widely recognized and prevalent
Other Accounting Literature †	11. Other accounting literature, including FASB Concepts Statements; AICPA Issues Papers; International Accounting Standards Committee Statements; GASB Statements, Interpretations, and Technical Bulletins; pronouncements of other professional associations or regulatory agencies; AICPA *Technical Practice Aids;* and accounting textbooks, handbooks, and articles	13. Other accounting literature, including GASB Concepts Statements; pronouncements in categories (*a*) through (*d*) of the hierarchy for nongovernmental entities when not specifically made applicable to state and local governments; FASB Concepts Statements; AICPA Issues Papers; International Accounting Standards Committee Statements; pronouncements of other professional associations or regulatory agencies; AICPA *Technical Practice Aids;* and accounting textbooks, handbooks, and articles

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* Paragraph references correspond to the paragraphs of SAS No. 69 (AU section 411) that describe the categories of the GAAP hierarchy.

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

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

AAM Section 3110
Assigning Personnel to the Engagement

General Comments

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

.02 Some procedures regarding assignment of personnel to the engagement are discussed in this section. The specific procedures adopted by a firm would not necessarily include all the procedures or be limited to those discussed. Overall firm requirements for assigning personnel to engagements are addressed in the *Quality Control Policies and Procedures for CPA Firms,* "Establishing Quality Control Policies and Procedures," (QC section 90), paragraphs .11—.12. (See AAM section 11,500.03—.06 for examples of quality control forms which can be helpful in assigning personnel to engagements.)

Engagement Planning Procedures

.03 A time budget for the engagement should generally be prepared to determine manpower requirements and to schedule field work. The engagement partner should approve the time budget prior to the beginning of field work. A time budget should have columns for budgeted time (in hours) for preliminary and final field work. Time budget forms differ depending upon firm preference and needs. Some firms use separate forms for the time budget report and the job progress report or analysis (see AAM section 3170.01 for "Audit Time Budget—Sample A"), whereas others combine these reports into one form (see AAM section 3170.02 for "Audit Time Budget—Sample B").

.04 Other alternatives include longer, more detailed sets of forms. These forms combine the features of a time budget, a source document for staff scheduling, and a job progress report that compares each assigned person's actual daily hours against the budget. Some firms use a shorter, less detailed form for jobs of less than a predetermined number of staff hours (for example, one hundred hours; see AAM section 3170.03 for "Audit Time Analysis—Short Form") and a longer form for jobs requiring more time (see AAM section 3170.04 for "Audit Time Analysis—Long Form"). Some firms use a weekly (or daily) progress report (see AAM section 3170.05, for example). This report, submitted by the accountant in charge, shows the time actually spent in relation to the estimate, the estimated additional time required, and the estimated variance from the original estimate.

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

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

a. Engagement size and complexity

b. Personnel availability

c. Special expertise

d. Timing of the work to be performed

e. Continuity and periodic rotation of personnel *f.* Opportunities for on-the-job training

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

.08 It is recommended that all procedures discussed in this section be documented in the accountant's work papers. A sample checklist documenting the procedures listed in this section is located in AAM section 3165.

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AAM Section 3115
Independence

General Comments

.01 Engagement planning should include procedures to provide the firm with reasonable assurance that persons at all organizational levels maintain independence to the extent required by the AICPA Code of Professional Conduct. Interpretation 101-1 of rule 101 of the rules of conduct (ET section 101.02), contains examples of instances wherein a firm's independence will be considered to be impaired.

.02 The procedures employed at the engagement level should be designed to ascertain whether the firm and its partners and employees have complied with all applicable independence rules, with emphasis on those related to financial interest, performance of accounting services for the client, and unpaid fees. Overall firm requirements for independence are addressed in the *Quality Control Policies and Procedures for CPA Firms,* "Establishing Quality Control Policies and Procedures," (QC section 90), paragraphs .09—.10. (See AAM section 11,500.01—.02 for independence checklists for employees and other auditors.)

.03 Some procedures regarding independence which a firm may employ in the planning phase of an engagement are discussed in this section. The specific procedures adopted by a firm would not necessarily include all these procedures or be limited to those discussed.

Engagement Planning Procedures

.04 Annual independence questionnaires should be reviewed for all engagement personnel by the engagement partner to assure that those individuals assigned to the engagement are independent.

.05 Accounts receivable from the client should be reviewed to ascertain whether any outstanding amounts take on some of the characteristics of loans and may, therefore, impair the firm's independence.

.06 According to SAS No. 1, section 543, *Part of Audit Performed by Other Independent Auditors* (AU section 543), the firm, when acting as principal auditor, should obtain confirmation of the independence of another firm engaged to perform segments of the audit. Written confirmation enables the principal auditor to document his assessment of the other auditor's independence in his audit work papers.

.07 In situations in which the accountant is not independent, the type of opinion to be issued should be discussed in the planning stage. A disclaimer of opinion should be issued as discussed in SAS No. 26, *Association With Financial Statements,* paragraphs 8—10 (AU section 504.08—.10), or the engagement should be turned into a compilation.

.08 It is recommended that all procedures discussed in this section be documented in the auditor's work papers. A sample checklist documenting the procedures listed in this section is located in AAM section 3165.

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AAM Section 3120
Knowledge of the Entity's Business

.01 The accountant should obtain a level of knowledge of the entity's business that will enable the accountant to plan and perform the audit in accordance with generally accepted auditing standards. That level of knowledge should enable the accountant to obtain an understanding of the events, and may have a significant effect on the financial statements. The level of knowledge customarily possessed by management relating to managing the entity's business is substantially greater than that which is obtained by the accountant in performing the audit. Knowledge of the entity's business helps the accountant in—

a. Identifying areas that may need special consideration.

b. Assessing conditions under which accounting data are produced, processed, reviewed, and accumulated within the operation.

c. Evaluating the reasonableness of estimates, such as valuation of inventories, depreciation, allowances for doubtful accounts, and percentage-of-completion of long-term contracts.

d. Evaluating the reasonableness of management representations.

e. Making judgments about the appropriateness of the accounting principles applied and the adequacy of disclosures.[1]

Engagement Planning Procedures

.02 The accountant should obtain a knowledge of matters that relate to the nature of the entity's business, its organization, and its operating characteristics. Such matters include, for example, the type of business, types of products and services, capital structure, related parties, locations and production, distribution, and compensation methods. The accountant should also consider matters affecting the industry in which the entity operates—such as economic conditions, government regulations, and changes in technology—as they relate to his audit. Other matters, such as accounting practices common to the industry, competitive conditions, and, if available, financial trends and ratios, should also be considered by the accountant.

.03 Knowledge of an entity's business is obtained through performing analytical procedures, prior experience with the entity or its industry, and inquiry of the entity's personnel. Working papers from prior years may contain useful information about the nature of the business, organizational structure, operating characteristics, and transactions that may require special consideration. Other sources an accountant may consult include AICPA audit and accounting guides, industry publications, financial statements of other entities in the industry, textbooks, periodicals, and individuals knowledgeable about the industry.

.04 The accountant should give thought to whether specialized skills are needed to consider the effect of computer processing on the audit, to understand the nature of internal control structure policies and procedures, or to design and perform audit procedures. If specialized skills are needed, the accountant should seek assistance from a professional who may be either on or outside the accountant's staff. If the use of such a professional is planned, the accountant should have sufficient computer-related knowledge to communicate the objectives of the other professional's work, to evaluate whether the specified procedures will meet the accountant's objectives, and to evaluate the results of the procedures applied as they relate to the nature, timing, and extent of other planned

[1] See SAS No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report,* paragraphs 4 and 6 (AU section 411.04 and .06).

audit procedures. The accountant's responsibilities for using such a professional are equivalent to those for using assistants.[2]

.05 The accountant should consider the methods the entity uses to process accounting information in planning the audit because such methods influence the design of the accounting system and the nature of control procedures. The extent to which computer processing is used in significant accounting applications, as well as the complexity of that processing, may also influence the nature, timing, and extent of audit procedures. Accordingly, when evaluating the effect of an entity's computer processing on an audit of financial statements, the accountant should consider matters such as—

a. The extent to which the computer is used in each significant accounting application.

b. The complexity of the entity's computer operations, including the use of an outside service center.[3]

c. The organizational structure of the computer processing activities.

d. The availability of data. Documents that are used to enter information into the computer for processing certain computer fields, and other evidential matter that may be required by the accountant, may exist only for a short period or only in computer-readable form. In some computer systems, input documents may not exist at all because information is entered directly into the system. An entity's data retention policies may require the accountant to request retention of some information for the review or to perform audit procedures at a time when the information is available.

e. The use of computer-assisted audit techniques to increase the efficiency of performing audit procedures.[4] Using computer-assisted audit techniques may also provide the accountant with an opportunity to apply certain procedures to an entire population of accounts or transactions. In addition, in some accounting systems, it may be difficult or impossible for the auditor to analyze certain data or test specific control procedures without computer assistance.

In addition, certain information generated by the computer for management's internal purposes may be useful in performing substantive tests (particularly analytical procedures).[5]

.06 It is recommended that all procedures discussed in this section be documented in the accountant's work papers. A sample checklist for documenting the procedures listed in this section is located in AAM section 3165.

[The next page is 3201.]

[2] Since the use of a specialist who is effectively functioning as a member of the audit team is not covered by SAS No. 11, *Using the Work of a Specialist* (AU section 336), a computer audit specialist requires the same supervision and review as any assistant.

[3] See SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AU section 324), and the related AICPA Audit and Accounting Guide, *Audits of Service-Center-Produced Records,* for guidance concerning the use of a service center for computer processing of significant accounting applications.

[4] See the AICPA Audit and Accounting Guide, *Computer-Assisted Audit Techniques,* for guidance relating to this specialized area.

[5] SAS No. 56, *Analytical Procedures* (AU section 329), describes the usefulness of and guidance pertaining to such procedures.

AAM Section 3125
Assessing Auditability

.01 The third standard of fieldwork requires that the auditor obtain sufficient competent evidential matter to afford a reasonable basis for the expression of an opinion on whether an entity's financial statements are fairly presented in conformity with generally accepted accounting principles.[1] The determination of whether the auditor is able to obtain sufficient competent evidential matter to issue an opinion on the financial statements is an issue of auditability. Many factors can influence the auditability of financial statements. There are two primary considerations, however, in evaluating whether the financial statements of a small business are, in fact, auditable: (1) the adequacy of accounting records and (2) management integrity.

Adequate Accounting Records

.02 To provide sufficient competent evidential matter, an entity's accounting system should be designed to identify the types of transactions executed so that the transactions can be recorded in the appropriate amounts in the correct accounting period. Accounting records should include the following information:

a. *Type of transaction.* Transactions should be described in sufficient detail to permit appropriate classification in the financial statements. Generally, accounting records need only indicate broad classes of transactions such as sales or payroll. In some circumstances, however, a more detailed description may be necessary, such as when payroll costs are to be allocated between inventory and expense. Identification of the type of transaction may be either explicit (for example, by using preprinted forms that describe the type of transactions, such as sales invoices) or implicit (for example, by using cash register tapes as a record of cash sales).

b. *Size of transaction.* Transactions should be described in a manner that permits the recording of monetary value in the financial statements. Although accounting records generally include the dollar amount of transactions or the quantities involved and related unit prices, an indication of quantities only may be sufficient if the monetary value of transactions can be determined by reference to data such as price lists, wage rates, or contracts.

c. *Period of time.* Accounting records should include the period in which the transactions occurred to permit the recording of transactions in the appropriate accounting period.

.03 The form of accounting records maintained by the client and the detail in which they are prepared varies because of a number of factors, such as the nature of the client's business, its size, and its organizational structure. For a small business to be auditable, there should exist adequate accounting records to identify the types of transactions executed and to record them at the appropriate amount in the correct accounting period.

.04 Many small businesses do not have elaborate accounting systems. Likewise, most small businesses have neither adequate segregation of duties nor a sophisticated internal control structure. Neither a formalized and complex accounting system nor a sophisticated control structure is required for a small business to be auditable.

SAS No. 55 Requirements

.05 The auditor should obtain a sufficient understanding of each of the three elements (control environment, accounting system, and control procedures) of the entity's internal control structure to plan the audit of the entity's financial statements. The understanding should include knowledge about the design of relevant policies, proce-

[1] Throughout this section, references to audit opinions regarding generally accepted accounting principles also include other comprehensive bases of accounting.

dures, and records and whether they have been placed in operation by the entity. In planning the audit, such knowledge should be used to:

a. Identify types of potential misstatements.

b. Consider factors that affect the risk of material misstatement.

c. Design substantive tests.

.06 Whether an internal control structure policy or procedure has been placed in operation is different from its operating effectiveness. In obtaining knowledge about whether policies and procedures have been placed in operation, the auditor determines that the entity is using them. Operating effectiveness, on the other hand, is concerned with how the policy, procedure, or record was applied, the consistency with which it was applied, and by whom. The auditor is not required to obtain knowledge about operating effectiveness as part of the understanding of the internal control structure used in planning the audit.

.07 The auditor's understanding of the internal control structure may sometimes raise doubts about the auditability of an entity's financial statements. Concerns about the integrity of the entity's management may be so serious as to cause the auditor to conclude that the risk of management misrepresentation in the financial statements is such that an audit cannot be conducted. Concerns about the nature and extent of an entity's records may cause the auditor to conclude that it is unlikely that sufficient competent evidential matter will be available to support an opinion on the financial statements.

Understanding the Internal Control Structure

.08 In making a judgment about the understanding of the internal control structure necessary to plan the audit, the auditor considers the knowledge obtained from other sources about the types of misstatements that could occur, the risk that such misstatements may occur, and the factors that influence the design of substantive tests. Other sources of such knowledge include previous audits and the understanding of the industry in which the entity operates. The auditor also considers his assessment of inherent risk, his judgment about materiality, and the complexity and sophistication of the entity's operations and systems as discussed in AAM section 3140.

Understanding of Control Environment

.09 The auditor should obtain sufficient knowledge of the control environment to understand management's attitude, awareness, and actions concerning the control environment. The auditor should concentrate on the substance of management's policies, procedures, and related actions rather than their form because management may establish appropriate policies and procedures but not act on them. The auditor must be knowledgeable about the entity's organizational structure. Although there are obviously limits on the formality of organization in a small business, some segregation of duties and designation of authority and responsibility generally can be accomplished. In addition, someone is responsible for engaging the auditor, responding to audit results, and exercising financial reporting oversight. How employees are told what is expected of them, how they are delegated authority and responsibility, and how their performances are monitored and evaluated also affect control consciousness in an entity. In addition, the planning and reporting system used, such as budgeting and forecasting, and personnel management practices are indications of attitudes and actions about internal control. Auditors should know how management has acted on these matters.

Understanding of Accounting System

.10 The auditor should obtain sufficient knowledge of the accounting system to understand:

a. The classes of transactions in the entity's operations that are significant to the financial statements.

b. How those transactions are initiated.

c. The accounting records, supporting documents, machine-readable information, and specific accounts in the financial statements involved in the processing and reporting of transactions.

d. The accounting processing involved from the initiation of a transaction to its inclusion in the financial statements, including how the computer is used to process data.

e. The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures.

Understanding of Control Procedures

.11 Generally, control procedures pertain to the proper authorization of transactions, segregation of duties, design and use of adequate documents and records, safeguards over assets and records and independent checks on performance, such as reconciliations, comparing documents, and management review of reports. Because some control procedures are integrated in specific components of the control environment and accounting system, as the auditor obtains an understanding of the control environment and accounting system, he is also likely to obtain knowledge about some control procedures. For example, in obtaining an understanding of the documents, records, and processing steps in the accounting system that pertain to cash, the auditor is likely to become aware of whether bank accounts are reconciled. The auditor should consider the knowledge about the presence or absence of control procedures obtained from the understanding of the control environment and accounting system in determining whether it is necessary to devote additional attention to obtaining an understanding of control procedures to plan the audit. Ordinarily, audit planning does not require an understanding of the control procedures related to each account balance, transaction class, and disclosure component in the financial statements or to every assertion relevant to those components.

Procedures to Obtain Understanding

.12 In obtaining an understanding of the internal control structure policies and procedures that are relevant to audit planning, the auditor should perform procedures to provide sufficient knowledge of the design of the relevant policies, procedures, and records pertaining to each of the three internal control structure elements and whether they have been placed in operation. This knowledge is ordinarily obtained through previous experience with the entity and procedures such as inquiries of appropriate management, supervisory, and staff personnel; inspection of entity documents and records; and observation of entity activities and operations. The nature and extent of the procedures performed generally vary from entity to entity and are influenced by the size and complexity of the entity, the auditor's previous experience with the entity, the nature of the particular policy or procedure, and the nature of the entity's documentation of specific policies and procedures. The auditor's assessments of inherent risk and judgments about materiality for various account balances and transaction classes also affect the nature and extent of the procedures performed to obtain the understanding. For example, the auditor may conclude that planning the audit of the prepaid insurance account does not require specific procedures to be included in obtaining the understanding of the internal control structure.

Documentation of Understanding

.13 The auditor should document the understanding of the entity's internal control structure elements obtained to plan the audit. The form and extent of this documentation is influenced by the size and complexity of the entity, as well as the nature of the entity's internal control structure. For example, documentation of the understanding of the internal control structure of a large complex entity may include flowcharts, questionnaires, or decision tables. For a small business, however, documentation in the form of a memorandum may be sufficient. Generally, the more complex the internal control structure and the more extensive the procedures performed, the more extensive the auditor's documentation should be.

Management Integrity

.14 Management integrity is an essential component of an audit engagement; without it, conflicts between management and the auditor are inevitable. As Mautz and Sharaf note, without management integrity

> No management responses to questions or representations could be given any credence whatever. It is doubtful whether the statements of employees, who must be under management control, could be accepted as in any way useful. Certainly the records and documents under management control would be regarded as completely unreliable.[2]

.15 The auditor should recognize the importance of management integrity and its potential impact on the financial statements. If the auditor has reason to doubt management's integrity, careful consideration should be given to the auditor's ability to express an opinion on the entity's financial statements.

.16 The auditor should also assess the risk that management has misstated the financial statements. SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities,* paragraphs 12 and 16—17 (AU section 316.12 and .16—.17), includes a discussion of management characteristics. AAM section 3145 discusses the assessment of risk of errors and irregularities in audit planning.

.17 Statement of Quality Control Standard No. 1, *System of Quality Control for a CPA Firm,* paragraph 7h (QC section 10.07h), states:

> In Acceptance and Continuance of Clients, "Policies and procedures should be established for deciding whether to accept or continue a client in order to minimize the likelihood of association with a client whose management *lacks integrity.*
>
> Suggesting that there should be procedures for this purpose does not imply that a firm vouches for the integrity or reliability of a client, nor does it imply that a firm has a duty to anyone but itself with respect to the acceptance, rejection or retention of clients. However, prudence suggests that a firm be selective in determining its professional relationships."

.18 A sample checklist documenting procedures listed in this section is located in AAM section 3165.

[The next page is 3221.]

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[2] R.K. Mautz and Hussein A. Sharaf, *The Philosophy of Auditing,* American Accounting Association (Sarasota, Fla.: 1961), p. 45.

AAM Section 3130
Preparing an Engagement Letter

.01 In an engagement letter, the firm and the client indicate their mutual understanding and agree to the nature and terms of the engagement. Engagement letters are a matter of sound business practice rather than a professional requirement. They cover the scope of services rendered and the responsibility the firm assumes. Therefore, they should be prepared with the care exercised in entering into other contracts.[1]

.02 Any limitations the client imposes on the scope of the engagement are specifically stated. Every letter covering audit, compilation, and review services should point out the limitations in the accountant's responsibility for the discovery of fraud and other irregularities.

.03 The engagement letter should also describe the terms of billing and payment. If unusual or extraordinary services are to be performed, the engagement letter should completely describe them.

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

.05 An engagement letter should be used for every engagement. A letter need not be issued more often than annually. Thus, interim audits or unaudited financial statement preparation can all be provided for in one annual letter. The letter should be sent to the client in duplicate so that a copy may be signed and returned for the accountant's files. Alternatively, the accountant may decide not to request that the client sign and return a copy of the letter. In that case, the letter should be sent to the client with an additional paragraph stating that, unless the client replies to the contrary, the accountant will assume the client agrees to the arrangements described in the letter. In those rare instances when the accountant decides that even this approach is not suitable, an engagement memorandum should be prepared for the file. This should provide all relevant information that would have been included in an engagement letter.

Reasons for Engagement Letters

.06 The advantages of using engagement letters are summarized below.

- *Type of engagement.* Describe the type of engagement (audit, compilation or review, or other accounting service) to be rendered.
- *Avoiding misunderstandings with the client.* In today's litigious environment an engagement letter is needed for both old and new clients. To avoid misunderstandings, the engagement letter should describe in detail the services to be rendered, the fee, and other terms and conditions of the engagement. Oral agreements may result in differences of recollection or understanding between the accountant and the client, and become completely valueless on the death of either.
- *Avoiding misunderstandings with the staff.* The members of the staff working on the engagement must have a complete understanding of what is required of them. A copy of the engagement letter in the working papers provides them an authoritative reference to supplement their oral instructions. This will eliminate confusion and misunderstanding about the type of engagement to be performed, the date and period covered by the financial statements, and the nature of the report expected to be rendered.

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[1] Statement on Standards for Accounting and Review Services (SSARS) No. 1, *Compilation and Review of Financial Statements,* paragraph 8 (AR section 100.08), states: "The accountant should establish an understanding with the entity, preferably in writing, regarding the services to be performed."

- *Legal liability.* The engagement letter should establish the scope and nature of the accountant's contractual obligation to the client by setting forth, clearly and specifically, the duties the accountant has agreed to perform. Many adverse consequences may result from failure to obtain a written engagement letter.

- *Practice management.* Generally, the executive (managing) partner reviews an engagement letter before the firm issues it. A timely review may be the vehicle that permits the executive partner to correct or amend the terms of the engagement, review the proposed fee and method of payment, and set up guidelines to minimize possible collection problems.

- *Contractual obligation.* Engagement letters recognize that a contract is created when the accountant agrees to render services and a client agrees to pay for them. The engagement letter should be clear-cut in delineating the duties and responsibilities of the client and of the firm.

- *Other.* An engagement letter permits the orderly assessment and review by partners and staff of the services performed and the terms of the engagement. This review facilitates drafting extensions or amendments to current or succeeding years' engagements.

.07 Some firms use one engagement letter to cover several types of services; others use separate engagement letters for each service rendered. In any case, firms should consider keeping separate internal records for time incurred on the separate types of services.

Special Considerations

.08 The following matters should be considered while preparing an engagement letter:

a. Whether the circumstances preclude an unqualified opinion, as in these examples:

- The auditor is retained after the beginning of the client's fiscal year, did not observe inventories or confirm receivables at the beginning of the year and was unable to satisfy self through application of alternative procedures.
- The client imposes restrictions on the scope of the audit. (SAS No. 58, *Reports on Audited Financial Statements,* paragraph 42 [AU section 508.42]).
- Significant litigation or other matters exist which may affect the opinion.

b. Whether fee should be stated as a range, in hourly rates, as standard per diem charges for the engagement, or as a maximum or flat fee

c. The person or persons to whom reports should be addressed

d. The number of copies needed of the report and the people to whom they are to be distributed

e. Deadlines for reports or analyses

f. Out-of-pocket costs

g. Additional work not contemplated in the original engagement

h. The condition of records or circumstances other than those contemplated in the engagement letter (for example, deficient internal control)

i. A retainer

j. One-time engagements

k. Start-up costs when the client changes accountants

l. Underwriters' requirements in connection with public offerings *m.* Long-time clients who have not previously been requested to approve engagement letters

n. The part of the work to be done by other accountants

Contents of Engagement Letters

.09 Following are the items ordinarily covered in engagement letters:

a. The name of the entity (and subsidiaries, if any) and its year end

b. Statements to be audited, compiled, or reviewed

c. The scope of services, as detailed as necessary, including limitations imposed by the client

d. The report(s) to be rendered

e. A disclaimer of responsibility for detecting fraud

f. Obligations of the client's staff to prepare schedules and statements (see item 2)

g. The requirement that the accountant read all printed material in which his report appears

h. The responsibility for preparation or review of tax returns and subsequent tax examinations

i. The fee, or the method of determining the fee

j. The frequency of billing and the client's obligations for payment including a retainer, if applicable

k. A provision for the client's acceptance signature, and the date

l. An expression of thanks for being selected as auditors or to perform other services

m. Before acceptance of a new engagement, an attempt that the successor auditor should make at certain communications with the predecessor auditor, as required in SAS No. 7, *Communications Between Predecessor and Successor Auditors,* paragraph 4 (AU section 315.04)

.10 The following is a list of instructions to a client's accounting staff. It includes analyses an accountant may expect the staff to prepare for the audit. Either include this list (or part of it) in the engagement letter or refer to it and then submit it as a separate memorandum.

- Balance the general ledger.
- Prepare a reconciliation for each bank account.
- Fill in and sign standard form(s) to confirm account balance information with financial institutions, to be provided by the accountant.
- Prepare a trade accounts receivable aging.
- Prepare accounts receivable confirmation letters, using drafts to be provided by the accountant.
- Prepare a schedule of accounts receivable from officers and employees.
- Prepare a schedule of bad debts written off during the year.
- Prepare a schedule of notes receivable. The notes should be available for inspection.
- Prepare a schedule of transactions with affiliated enterprises.
- Price, extend, and foot the original inventory sheets, and have them available.
- Analyze all transactions affecting marketable securities.

- Prepare an insurance schedule. The policies should be available for inspection.
- Prepare a schedule of property and equipment additions and retirements.
- Prepare a depreciation schedule.
- Prepare a schedule of life insurance for officers.
- Prepare a schedule of accounts payable. The creditor's regular monthly statements for [*date*] should be retained and made available.
- Prepare a schedule of notes payable.
- The corporate stock book and minutes should be up to date and available for inspection.
- Prepare a schedule of all transactions to partners' capital and drawing accounts.
- A copy of the partnership agreement or corporate charter should be available for inspection.
- Copies of all leases, including equipment rental contracts, should be available for inspection.
- Copies of employment contracts with salesmen or executives should be available for inspection
- Copies of pension, profit-sharing, deferred compensation, and stock option agreements, and letters of acceptance from the Treasury Department, should be available for inspection.
- Prepare a schedule of repairs in excess of $______.
- Prepare a schedule of each officer's salary and expense account payments.
- Prepare a schedule of contributions.
- Prepare a schedule of tax expense.
- Prepare a schedule of professional fees.

.11 An engagement letter may optionally include—

a. A description of a particular audit procedure, if requested by the client or deemed necessary for the protection of the auditor. (The detailed audit program should not be made available to client personnel, orally or otherwise.)

b. The extent and timing of interim auditing.

c. The name of the client's personnel to be contacted during engagement.

d. A study and evaluation of internal control and a report thereon. (This would be a special engagement, not a part of the normal audit routine.)

e. Interim contact and cooperation with the internal auditor.

f. A list of services specifically excluded.

g. Acknowledgement by the client of its responsibility for the financial statements. (Because auditors of smaller, non-public entities often may maintain accounting records, prepare financial statements, and advise management about appropriate accounting principles, such an acknowledgement may be particularly appropriate for such clients.)

h. A statement that the client will be informed of any reportable conditions in the internal control structure that come to the auditor's attention during the audit of financial statements. (Such a communication, either orally or in writing, is required by SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* [AU section 325].)

.12 Following is a list of common engagement letter deficiencies:

a. Reference in the letter to audit of the books and records rather than to audit of financial statements

b. Adverse comments about other firms

c. Failure to specify *in detail* the services to be rendered when a maximum fee is quoted

d. Inclusion of a review of the internal control structure as one of the services when what is really intended is a consideration of the internal control structure as required by auditing standards

e. Failure to identify accounting or other problems that may have an effect on the opinion

f. Failure to change, in writing, the terms of the engagement when conditions are found to be different (such as the inability to express an opinion without extensive additional auditing because the internal controls were found deficient)

g. Failure to include fee basis and payment terms

h. Failure to identify subsidiaries

i. Failure to identify specific tax returns to be prepared

Client Approval

.13 It is recommended that the client's written approval of general arrangements for the engagement be secured by the accountant before proceeding with the engagement (especially in new engagements). The addressee of the letter is usually the one asked to approve the engagement. In some situations the accountant may not deem it advisable to send a client an engagement letter tht requests his signature. An alternative approach might be to send the client a letter confirming the terms of the engagement, without asking him to sign it, but asking him to reply if he does not agree with the terms.

Addressee of Letter

.14 Ordinarily, the accountant should address the letter to whomever retained the firm. If it is a corporate client's board of directors, the letter should be addressed to the board, its chairperson, or the chief executive, depending on the arrangement. If the accountant is appointed by an audit committee, it is appropriate to address the letter to the committee chairperson. If the engagement was arranged with a corporate official, the letter may be addressed to the official, personally, indicating the official's title, followed by the name of the corporation.

Investigatory Procedures for Individuals

.15 When credit information is requested about individuals who are new clients, the investigative procedures are subject to the Fair Credit Reporting Act of 1971.

.16 An individual should be informed in writing that an investigative consumer report, including information about the individual's character, general reputation, personal characteristics, and mode of living is being made. The individual should also be advised, within three days of the time the report is requested, that he may within a reasonable time, by written request, be furnished disclosure of the nature and scope of the investigation.[2]

Filing of Engagement Letters

.17 The signed engagement letter (or original of the conforming letter) is a contract and should be filed in the client's permanent file. A copy may also be filed with the current working papers, if desired, because of the possible overlapping of billing and collecting as compared to the term of the actual engagement. This also permits easy access when reference to the previous year's letter is needed to prepare the letter for the following year's engagement.

[2] For a more complete discussion, see Carlos Martinez, "A Guide to the Fair Credit Reporting Act," *The Practical Lawyer,* December 1972.

.18 A sample checklist documenting procedures listed in this section is located in AAM section 3165.

.19 See AAM section 3175 for sample engagement letters.

[The next page is 3251.]

AAM Section 3135
Assessment of Control Risk

General Comments

.01 Upon obtaining an understanding of the elements of the internal control structure as discussed in AAM section 3125, the auditor must assess control risk for financial statement assertions to determine the nature, timing and extent of tests of controls and substantive testing. The risk of material misstatement in financial statement assertions consists of inherent risk, control risk, and detection risk as discussed in AAM section 3140. Assessing control risk is the process of evaluating the effectiveness of an entity's internal control structure policies and procedures in preventing or detecting material misstatements in financial statements. Control risk should be assessed in terms of financial statement assertions.

Consideration of the Internal Control Structure in Assessing Control Risk

.02 After obtaining the understanding of the internal control structure the auditor may assess control risk at the maximum level for some or all assertions because he believes policies and procedures are unlikely to pertain to an assertion, are unlikely to be effective, or because evaluating their effectiveness would be inefficient.

.03 Assessing control risk at below the maximum level involves:

a. Identifying specific internal control structure policies and procedures relevant to specific assertions that are likely to prevent or detect material misstatements in those assertions.

b. Performing tests of controls to evaluate the effectiveness of such policies and procedures.

.04 In identifying internal control structure policies and procedures relevant to specific financial statement assertions, the auditor should consider that the policies and procedures can have either a pervasive effect on many assertions or a specific effect on an individual assertion, depending on the nature of the particular internal control structure element involved. The control environment and accounting system often have a pervasive effect on a number of account balance or transaction classes and, therefore, can often affect many assertions.

.05 Conversely, some control procedures often have a specific effect on an individual assertion embodied in a particular account balance or transaction class. For example, the control procedures that an entity established to ensure that its personnel are properly counting and recording the annual physical inventory relate directly to the existence assertion for the inventory account balance.

.06 Internal control structure policies and procedures can either be directly or indirectly related to an assertion. The more indirect the relationship, the less effective that policy or procedure may be in reducing control risk for that assertion.

.07 Procedures directed toward either the effectiveness of the design or operation of an internal control structure policy or procedure are referred to as tests of controls. Tests of controls directed toward the effectiveness of the design of an internal control structure policy or procedure are concerned with whether that policy or procedure is suitably designed to prevent or detect material misstatements in specific financial statement assertions. Tests to obtain such evidential matter ordinarily include procedures such as inquiries of appropriate entity personnel, inspection of documents and reports, and observation of the application of specific internal control structure policies and procedures.

.08 Tests of controls directed toward the operating effectiveness of an internal control structure policy or procedure are concerned with how the policy or procedure was applied, the consistency with which it was applied during the audit period, and by whom it was applied. These tests ordinarily include procedures such as inquiries of appropriate entity personnel, inspection of documents and reports indicating performance of the policy or procedure, observation of the application of the policy or procedure, and reperformance of the application of the policy or procedure by the auditor. In some circumstances, a specific procedure may address the effectiveness of both design and operation. However, a combination of procedures may be necessary to evaluate the effectiveness of the design or operation of an internal control structure policy or procedure.

.09 The conclusion reached as a result of assessing control risk is referred to as the assessed level of control risk. In determining the evidential matter necessary to support a specific assessed level of control risk at below the maximum level, the auditor should consider the characteristics of evidential matter. Generally, however, the lower the assessed level of control risk, the greater the assurance the evidential matter must provide that the internal control structure policies and procedures relevant to an assertion are designed and operating effectively.

.10 The auditor uses the assessed level of control risk (together with the assessed level of inherent risk) to determine the acceptable level of detection risk for financial statement assertions. The auditor uses the acceptable level of detection risk to determine the nature, timing, and extent of the auditing procedures to be used to detect material misstatements in the financial statement assertions. Auditing procedures designed to detect such misstatements are substantive tests.

Documentation of the Assessed Level of Control Risk

.11 In addition to the documentation of the understanding of the internal control structure, the auditor should document the basis for his conclusions about the assessed level of control risk. Conclusions about the assessed level of control risk may differ as they relate to various account balances or classes of transactions. However, for those financial statement assertions where control risk is assessed at the maximum level, the auditor should document his conclusion that control risk is at the maximum level but need not document the basis for that conclusion. For those assertions where the assessed level of control risk is below the maximum level, the auditor should document the basis for this conclusion that the effectiveness of the design and operation of internal control structure policies and procedures supports that assessed level. The nature and extent of the auditor's documentation are influenced by the assessed level of control risk used, the nature of the entity's internal control structure and the nature of the entity's documentation of its internal control structure.

Further Reduction in the Assessed Level of Control Risk

.12 After obtaining the understanding of the internal control structure and assessing control risk, the auditor may desire to seek a further reduction in the assessed level of control risk for certain assertions. In such cases, the auditor considers whether additional evidential matter sufficient to support a further reduction is likely to be available, and whether it would be efficient to perform tests of controls to obtain that evidential matter. The results of the procedures performed to obtain the understanding of the internal control structure, as well as pertinent information from other sources, help the auditor to evaluate those two factors.

.13 In considering efficiency, the auditor recognizes that additional evidential matter that supports a further reduction in the assessed level of control risk for an assertion would result in less audit effort for the substantive tests of that assertion. The auditor weighs the increase in audit effort associated with the additional tests of controls that is necessary to obtain such evidential matter against the resulting decrease in audit effort associated with the reduced substantive tests. When the auditor concludes it is inefficient to obtain additional evidential matter for specific assertions, the auditor uses the assessed level of control risk based on the understanding of the internal control structure in planning the substantive tests for those assertions.

.14 For those assertions for which the auditor performs additional tests of controls, the auditor determines the assessed level of control risk that the results of those tests will support. This assessed level of control risk is used in determining the appropriate detection risk to accept for those assertions and, accordingly, in determining the appropriate detection risk to accept for those assertions and, accordingly, in determining the nature, timing, and extent of substantive tests for such assertions.

.15 A sample checklist documenting procedures listed in this section is located in AAM section 3165.

[The next page is 3271.]

AAM Section 3140
Assessing Audit Risk and Materiality

.01 In rendering an unqualified opinion that states "In our opinion, the financial statements present fairly in all material respects . . . in conformity with generally accepted accounting principles . . .," the auditor is giving implicit recognition to the concepts of audit risk and materiality. The existence of audit risk is implicit in the phrase "in our opinion." Materiality is explicit in the phrase "presents fairly in all material respects in conformity with generally accepted accounting principles."

Audit Risk

.02 SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AU section 312), defines audit risk as "the risk that the auditor may unknowingly fail to appropriately modify his opinion on financial statements that are materially misstated." In other words, audit risk is the risk that the auditor will give an unqualified opinion on financial statements that are materially incorrect.

.03 In addition to audit risk, the auditor is also exposed to business risk in every audit engagement. Business risk is the risk that the auditor's professional practice will suffer loss or injury from litigation or adverse publicity in connection with an audit of financial statements. Business risk is present even though the auditor conducts the audit in accordance with generally accepted auditing standards. For example, the auditor may conduct a proper audit and yet be sued by a disgruntled party without cause. Even though the auditor may win the lawsuit in such circumstances, the auditor's professional reputation may be damaged. This type of risk differs from audit risk. Business risk cannot be used to reduce audit risk under generally accepted auditing standards.

Risk Components

.04 SAS No. 47, states that audit risk consists of three components:

a. *Inherent risk* is the susceptibility of an assertion to a material misstatement, assuming that there are no related internal control structure policies or procedures. The risk of such misstatement is greater for some assertions and related balances or classes than for others. For example, complex calculations are more likely to be misstated than simple calculations. Cash is more susceptible to theft than is an inventory of coal. Accounts consisting of amounts derived from accounting estimates pose greater risks than do accounts consisting of relatively routine, factual data. External factors also influence inherent risk. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement.

b. *Control risk* is the risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by the entity's internal control structure policies or procedures. That risk is a function of the effectiveness of the design and operation of the internal control structure policies or procedures. Some control risk will always exist because of the inherent limitations of any internal control structure.

c. *Detection risk* is the risk that the auditor will not detect a material misstatement that exists in an assertion. Detection risk is a function of the effectiveness of an auditing procedure and of its application by the auditor. It arises partly from uncertainties that exist when the auditor does not examine 100 percent of an account balance or class of transactions and partly because of other uncertainties that exist even if he were to examine 100 percent of the balance or class. Such other uncertainties arise because an auditor might select an inappropriate auditing procedure, misapply an appropriate procedure, or misinterpret the audit results. These other uncertainties can be reduced to a negligible level through adequate planning and supervision and conduct of a firm's audit practice in accordance with appropriate quality control standards.

.05 Inherent risk and control risk differ from detection risk in that they exist independently of the audit of the financial statements. Inherent risk and control risk are functions of the client and its environment, regardless of whether an audit is conducted. Detection risk, on the other hand, relates to the auditor's procedures and can be changed at the auditor's discretion. The assessment of the potential for material misstatements occurs when the auditor considers inherent risk.

.06 The client may establish internal control structure policies and procedures to detect material misstatements and remove them from the accounting system. Ideally, the control structure should detect all material misstatements before they enter the financial statements, but sometimes the control structure may not detect a material misstatement even though it went through the control structure. For example, there may be a weakness or breakdown in the client's structure that allows a misstatement to remain undetected.

.07 Even when a client has effective internal control structure policies and procedures, certain misstatements can bypass the structure because of special circumstances. For example, if a client had an unusual exchange of nonmonetary assets, no internal control structure policies and procedures may have been established to detect a misstatement in this special circumstance.

.08 If the client's internal control structure does not detect and remove misstatements, they will flow through and be included in the financial statements. The auditor's responsibility is to design audit procedures that provide reasonable assurance that material misstatements do not remain in financial statements.

.09 The auditor will never have absolute assurance that no material misstatements exist in the financial statements. From a cost-benefit perspective, an audit providing absolute assurance that no material misstatements exist in the financial statements is impractical. Thus, the auditor designs audit tests to provide *reasonable assurance* that there are no material misstatements in the financial statements. There is always some risk that (*a*) material misstatements will exist; (*b*) they will not be detected by the client's internal control structure; (*c*) they will not be detected by the auditor; or (*d*) they will affect the financial statements. The auditor's responsibility is to reduce audit risk to an acceptably low level. Both the tests of details (tests of balances and tests of transactions) and analytical procedures are means by which the auditor detects material misstatements.

Risk Assessment and Planning

.10 In planning the audit engagement, the auditor should assess inherent risk and control risk to determine how much detection risk can be accepted while still restricting audit risk to an acceptably low level. As the auditor's assessment of inherent risk and control risk decreases, the acceptable level of detection risk increases. The auditor should not rely on the assessments of inherent risk and control risk to the exclusion of performing substantive tests. In fact, for a small business with limited segregation of duties, the auditor often assesses inherent risk and control risk at their maximum and relies completely on substantive tests to reduce audit risk to an acceptably low level.

Quantifying Risk

.11 The auditor's assessments of audit risk and its components of inherent risk, control risk, and detection risk are matters of *professional judgment*. Although the auditor may use quantitative tools such as decision tables and structured aids such as questionnaires to assist in assessing risk components, the ultimate assessment of audit risk is based on professional judgment.

.12 Some auditors confuse audit risk with risk associated with statistical sampling and thus erroneously assume that all audit risk can be quantified. Statistical sampling can be used to quantify the risk of misstatement in determining the extent of audit testing; that is, by using statistical sampling techniques, the auditor can quantify the risk of relying on the results of applying a procedure to a sample, rather than to 100 percent of the items in an account balance or class of transaction. However, quantitative assessment of risk using statistical sampling techniques is only one element of audit risk. As noted previously, audit risk is composed of control risk, detection risk, and inherent risk. Detection risk, which relates to audit procedures, is a function of the nature and timing of audit procedures as well as of the extent of their application.

.13 Generally accepted auditing standards do not require the auditor to quantify risk or to perform any additional analyses of risk. Those standards simply require the auditor to plan the audit so that there is a low level of risk that an unqualified opinion will be expressed when, in fact, the financial statements are materially misstated.

Materiality

.14 SAS No. 47 states that audit risk is "the risk that the auditor may unknowingly fail to appropriately modify his opinion on financial statements that are *materially* misstated." As SAS No. 47 observes, audit risk and materiality should be considered together in determining the nature, timing, and extent of auditing procedures and in evaluating the results of those procedures.

.15 Materiality is the criterion used by accountants and auditors to distinguish between unimportant and important matters. Obviously, some misstatements could be included in the financial statements without precluding the auditor from expressing an opinion that the financial statements are fairly presented in all material respects in conformity with generally accepted accounting principles. The auditor's consideration of materiality is a matter of professional judgment and is influenced by a perception of the needs of the users of the financial statements. In determining the materiality of an item, the auditor should consider the nature and amount of the item in relation to the financial statements being audited.

In Planning

.16 In planning the audit, materiality should be viewed as an allowance for likely and potential undetected misstatements. Of course, in planning, the auditor cannot anticipate all the factors that will ultimately influence judgment about materiality in the evaluation of audit findings at the completion of the audit. Thus, materiality in planning may differ from materiality used in evaluating results at the conclusion of the audit. If the materiality amount used in evaluating audit findings is reduced significantly from the amount used in planning, the auditor should reevaluate—on the basis of planning materiality—the sufficiency of the auditing procedures that were performed. For example, an auditor may propose audit adjustments that significantly lower revenues. As a result of these adjustments, the auditor's assessment of materiality at the conclusion of the audit may be reduced (for example, from $1,000 to $500). In view of the lower threshold of materiality, the auditor should evaluate whether the audit evidence obtained is sufficient.

Quantifying Materiality

.17 Professional standards require auditors to make a preliminary judgment about materiality in the planning stage of an audit (SAS No. 47, paragraph 3 [AU section 312.03]). Although no authoritative body has established specific guidelines for materiality, some auditors believe that there are certain rules of thumb that can be used in making a preliminary assessment of materiality.

.18 Generally, auditors agree that materiality guidelines should be relative rather than absolute. In other words, materiality is usually set as a percentage rather than as an absolute amount. For example, an absolute amount such as $100,000 may be immaterial to a large, multinational corporation but very material to a small, closely held company. To apply percentage guidelines, auditors must determine what base to use. Generally, auditors select a base that is relatively stable and predictable. Bases commonly used include net income before taxes, revenues, and total assets. Because financial statements are interrelated, and also for reasons of efficiency, auditors normally consider materiality in terms of the smallest amount that would be material to the financial statements. Generally, misstatements become material to income before they become material to the balance sheet. As a consequence, net income before taxes is often selected as the base.

.19 In small business audits, auditors sometimes make a number of significant audit adjustments. Thus, income before taxes may vary too much to be useful as a base. When net income before taxes is not used as a base, auditors sometimes use either total revenue or an average of net income for several prior periods.

Example

.20 A common rule of thumb for materiality is 5 to 10 percent of pretax income. Some auditors apply this rule of thumb so that items less than 5 percent of normal pretax income are considered immaterial, whereas items that are more than 10 percent are material. For items between 5 and 10 percent, judgment is applied. For example, when unusual factors exist (perhaps the company is about to be sold for a multiple of audited earnings) auditors would tend to classify items between 5 and 10 percent as material. Others use 1 or 1.5 percent of the larger of total assets or revenues. (See Exhibit 1 for a sample planning materiality worksheet.)

Exhibit 1

	Initials	Date
Done	______	______
Reviewed	______	______

Client Name
Planning Materiality Worksheet
Balance Sheet Date

1.	Unaudited total assets at balance sheet date	______
2.	Unaudited total revenues at balance sheet date	______
3.	Select the larger of *1* or *2*	______
4.	Select a multiplier if audit risk is normal, or, if better than normal, select .01	______
5.	Multiply *3* times *4*	______
6.	Unaudited pretax income (or equivalent if not a for-profit entity)	______
7.	Select a multiplier if audit risk is normal, or, if better than normal, select .1	______
8.	Multiply *6* times *7*	______
9.	Evaluate *5* and *8* along with other relevant factors and determine materiality for audit planning purposes	______

.21 Consideration of which base to use should include such factors as income variability and the nature of the client's business and industry. For a nonprofit organization, for example, the auditor would probably use total assets or revenues as a base, since pretax income is not meaningful.

.22 A sample checklist documenting procedures listed in this section is located in AAM section 3165.

[The next page is 3291.]

AAM Section 3145
Errors and Irregularities

General Comments

.01 The auditor should assess the risk that errors and irregularities may cause the financial statements to contain a material misstatement. Based on that assessment, the auditor should design the audit to provide reasonable assurance of detecting errors and irregularities that are material to financial statements.

.02 The auditor should exercise:

a. Due care in planning, performing, and evaluating the results of audit procedures.

b. The proper degree of professional skepticism to achieve reasonable assurance that material errors or irregularities will be detected.

Consideration of Audit Risk at the Financial Statement Level

.03 An assessment of the risk of material misstatements should be made during planning. The auditor's understanding of the internal control structure should either heighten or mitigate the auditor's concern about the risk of material misstatements.

.04 Factors such as those listed below may be considered:

a. Management characteristics (e.g., management's attitude toward reporting is unduly aggressive).

b. Operating and industry characteristics (e.g., profitability of an entity relative to its industry is inadequate or inconsistent).

c. Engagement characteristics (e.g., significant and unusual related party transactions not in the ordinary course of business are present).

.05 The size, complexity, and ownership characteristics of the entity have a significant influence on the risk factors considered to be important.

.06 The auditor should assess risk of management misrepresentation by reviewing information obtained about risk factors and the internal control structure. Matters such as the following may be considered:

a. Are there known circumstances that may indicate a management predisposition to distort financial statements, such as frequent disputes about aggressive application of accounting principles that increase earnings?

b. Are there indications that management has failed to establish policies and procedures that provide reasonable assurance of reliable accounting estimates, such as personnel who develop estimates appearing to lack necessary knowledge and experience?

c. Are there conditions that indicate lack of control of activities, such as constant crisis conditions in operating or accounting areas?

d. Are there indications of a lack of control over computer processing, such as a lack of control over access to applications that initiate or control the movement of assets (e.g., a demand-deposit application in a bank)?

e. Are there indications that management has not developed or communicated adequate policies and procedures for security of data or assets, such as not investigating employees in key positions before hiring?

The Auditor's Response to Risk at the Financial Statement Level

.07 The auditor's overall judgment about the level of risk in an engagement may affect engagement staffing, extent of supervision, overall strategy for expected conduct and scope of audit, and degree of professional skepticism applied.

.08 Ordinarily, higher risk requires more experienced personnel or more extensive supervision by the auditor with final responsibility for the engagement during both the planning and conduct of the engagement.

.09 Higher risk may cause the auditor to expand the extent of procedures applied, apply procedures closer to or as of the balance sheet date, or modify the nature of procedures.

Consideration of Audit Risk at the Balance or Class Level

.10 Examples of factors that may influence the auditor's consideration of risk of material misstatement at balance or class level are:

a. Complexity and contentiousness of accounting issues affecting balance or class.

b. Nature, cause, and amount of known and likely misstatements detected in the balance or class in the prior audit.

c. Susceptibility of related assets to misappropriation.

d. Extent of judgment involved in determining the total balance or class.

Professional Skepticism

.11 An audit should be planned and performed with an attitude of professional skepticism. The auditor neither assumes that management is dishonest nor assumes unquestioned honesty.

.12 When approaching difficult-to-substantiate assertions, the auditor should recognize the increased importance of factors that bear on management integrity. A presumption of management dishonesty, however, would be contrary to the accumulated experience of auditors. Moreover, if dishonesty were presumed the auditor would potentially need to question the genuineness of all records and documents obtained from the client and would require conclusive rather than persuasive evidence to corroborate all management representations. An audit conducted on these terms would be unreasonably costly and impractical.

Professional Skepticism in Audit Planning

.13 Whenever the auditor has reached a conclusion that there is significant risk of material misstatement, the auditor reacts in one or more ways.

.14 The auditor should consider this assessment in determining the nature, timing or extent of procedures, assigning staff, or requiring appropriate levels of supervision.

.15 The auditor may identify specific transactions involving senior management and confirm the details with appropriate external parties and review in detail all material accounting entries prepared or approved by senior management.

.16 The auditor should consider whether accounting policies are acceptable in circumstances. Increased risk of intentional distortion of the financial statements should cause greater concern about whether accounting principles that are otherwise generally accepted are being used in inappropriate circumstances to create a distortion of earnings.

.17 When evaluation at the financial statement level indicates significant risk, the auditor requires more or different evidence to support material transactions than would be the case in the absence of such risk. For example, the auditor may perform additional procedures to determine that sales are properly recorded, giving consideration to the possibility that the buyer has a right to return the product. Transactions that are both large and unusual, particularly at year-end, should be selected for testing.

.18 A sample checklist documenting procedures listed in this section is located in AAM section 3165.

[The next page is 3301.]

AAM Section 3150
Illegal Acts

General Comments

.01 The term "illegal acts" refers to violations of laws or governmental regulations. Illegal acts by clients do not include personal misconduct by the entity's personnel unrelated to their business activities.

.02 Whether an act is illegal is a determination that is normally beyond the auditor's professional competence. The auditor's training and experience may provide a basis for recognition that some client acts coming to his attention may be illegal.

Direct and Material Effect Illegal Acts

.03 The auditor considers laws and regulations that are generally recognized by auditors to have a direct and material effect on the determination of financial statement amounts (except disclosure of contingencies). For example, tax laws affect accruals and the amount recognized as expense in the accounting period; applicable laws and regulations may affect the amount of revenue accrued under government contracts.

.04 The auditor considers such laws or regulations from the perspective of their known relation to audit objectives derived from financial statement assertions rather than from the perspective of legality *per se*.

.05 The auditor's responsibility to detect and report misstatement resulting from illegal acts having a direct and material effect on the determination of financial statement amounts is the same as that for material errors and irregularities as described in SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities* (AU section 316).

Other Illegal Acts

.06 Entities may be affected by many other laws or regulations, including those related to securities trading, occupational safety and health, food and drug administration, environmental protection, equal employment, and price-fixing or other antitrust violations. Generally, these laws and regulations relate more to an entity's operating aspects than to its financial and accounting aspects and their financial statement effect is indirect.

.07 An auditor ordinarily does not have sufficient basis for recognizing possible violations of such laws and regulations. Their indirect effect is normally the result of the need to disclose a contingent liability because of the allegation or determination of illegality.

Engagement Planning Procedures

.08 The auditor should assess the risks that the entity has not complied with laws and regulations which have a direct and material effect on the determination of financial statement amounts (except disclosure of contingencies) in the planning phase of the audit.

.09 Matters that may influence the auditor's assessment include:

a. Management's understanding of the requirements of laws and regulations pertinent to audit objectives.

b. The nature and extent of noncompliance noted in prior audits.

c. Changes in requirements since the last audit.

d. Internal control structure elements designed to give management reasonable assurance that the entity complies with those laws and regulations.

e. The client's policy relative to the prevention of illegal acts.

.10 Normally, there is no need to include audit procedures specifically designed to detect illegal acts.

.11 A sample checklist documenting the procedures listed in this section is located in AAM section 3165.

[The next page is 3331.]

AAM Section 3155
Analytical Procedures

General Comments

.01 Understanding financial relationships is essential in planning and evaluating the results of analytical procedures and generally requires knowledge of the client and the industry or industries in which the client operates. An understanding of the purposes of analytical procedures and the limitations of those procedures is also important. Accordingly, the identification of the relationships and types of data used, as well as conclusions reached when recorded amounts are compared to expectations, requires judgment by the auditor.

.02 Analytical procedures are used for the following purposes:

a. To assist the auditor in planning the nature, timing, and extent of other auditing procedures.

b. As a substantive test to obtain evidential matter about particular assertions related to account balances or classes of transactions.

c. As an overall review of the financial information in the final review stage of the audit.

Analytical procedures should be applied to some extent for the purposes referred to in (*a*) and (*c*) above for all audits of financial statements made in accordance with generally accepted auditing standards. In addition, in some cases, analytical procedures can be more effective or efficient than tests of details for achieving particular substantive testing objectives.

.03 Analytical procedures involve comparisons of recorded amounts or ratios developed from recorded amounts, to expectations developed by the auditor. The auditor develops such expectations by identifying and using plausible relationships that are reasonably expected to exist based on the auditor's understanding of the client and of the industry in which the client operates. Following are examples of sources of information for developing expectations:

a. Financial information for comparable prior period(s) giving consideration to known changes.

b. Anticipated results—for example, budgets or forecasts including extrapolations from interim or annual data.

c. Relationships among elements of financial information within the period.

d. Information regarding the industry in which the client operates—for example, gross margin information.

e. Relationships of financial information with relevant nonfinancial information.

Engagement Planning Procedures

.04 The purpose of applying analytical procedures in planning the audit is to assist in planning the nature, timing, and extent of auditing procedures that will be used to obtain evidential matter for specific account balances or classes of transactions. To accomplish this, the analytical procedures used in planning the audit should focus on (*a*) enhancing the auditor's understanding of the clients' business and the transactions and events that have occurred since the last audit date, and (*b*) identifying areas that may represent specific risks relevant to the audit. Thus, the objective of the procedures is to identify such things as the existence of unusual transactions and events, and amounts, ratios and trends that might indicate matters that have financial statement and audit planning ramifications.

.05 Analytical procedures used in planning the audit generally use data aggregated at a high level. Furthermore, the sophistication, extent and timing of the procedures, which are based on the auditor's judgment, may vary widely depending on the size and complexity of the client. For some entities, the procedures may consist of reviewing changes in account balances from the prior to the current year using the general ledger or the auditor's preliminary or unadjusted working trial balance. In contrast, for other entities, the procedures might involve an extensive analysis of quarterly financial statements. In both cases, the analytical procedures, combined with the auditor's knowledge of the business, serve as a basis for additional inquiries and effective planning.

.06 Although analytical procedures used in planning the audit often use only financial data, sometimes relevant non-financial information is considered as well. For example, number of employees, square footage of selling space, volume of goods produced, and similar information may contribute to accomplishing the purpose of the procedures.

.07 A sample checklist documenting procedures listed in this section is located in AAM section 3165.

[The next page is 3351.]

AAM Section 3160
Audit Strategies and the Audit Program

.01 The nature, timing, and extent of audit testing is discussed in AAM section 5000.

.02 A sample checklist documenting procedures listed in AAM section 5000 is located in AAM section 3165.

[The next page is 3361.]

AAM Section 3165
Illustrative Planning Checklist

	Done by	Date
.01 A. Understanding the Assignment		
1. Have engagement personnel considered the following matters in planning the engagement:		
a. The entity's accounting policies and procedures	___	___
b. Financial statement items likely to require adjustment	___	___
c. The nature of reports expected to be rendered (for example, a report on consolidated or consolidating financial statements, reports on financial statements filed with the SEC, or special reports such as those on compliance with contractual provisions)	___	___
2. In planning the audit, have engagement personnel—		
a. Discussed the type, scope, and timing of the audit with the entity's management, board of directors, or audit committee?	___	___
b. Considered the effects of applicable accounting and auditing pronouncements, particularly new ones?	___	___
c. Coordinated the assistance of entity personnel in data preparation?	___	___
d. Determined the extent of involvement, if any, of consultants, other independent auditors, specialists, and internal auditors?	___	___
.02 B. Assigning Personnel to the Engagement		
1. Has a time budget for the engagement been prepared to determine manpower requirements and to schedule fieldwork?	___	___
2. Has the engagement partner approved the time budget prior to the beginning of fieldwork?	___	___
3. Have the following factors been considered in achieving a balance of engagement manpower requirements, personnel skills, individual development, and utilization:		
a. Engagement size and complexity?	___	___
b. Personnel availability?	___	___
c. Special expertise required?	___	___
d. Timing of the work performed?	___	___
e. Continuity and periodic rotation of personnel?	___	___
f. Opportunities for on-the-job training?	___	___
4. Has the scheduling and staffing of the engagement been approved by the partner with final responsibility for the engagement, so that the partner can consider the qualifications, experience, and training of personnel to be assigned?	___	___
.03 C. Independence		
1. If acting as principal auditor, has written confirmation of the independence of other firms engaged to perform segments of the audit been obtained?	___	___
2. Have annual independence questionnaires been reviewed for all engagement personnel to assure that those individuals assigned to the engagement are independent?	___	___
3. Have accounts receivable from the client been reviewed to ascertain whether any outstanding amounts take on some of the characteristics of loans and may, therefore, impair the firm's independence?	___	___

	Done by	Date
4. In situations in which the firm is not independent, has the issuance of a disclaimer of opinion been discussed in accordance with Statement on Auditing Standards (SAS) No. 26, *Association With Financial Statements,* paragraphs 8—10 (AU section 504.08—.10)?	____	____

.04 D. **Knowledge of the Entity's Business**

	Done by	Date
1. Has an initial, overall understanding of the clients' operations been obtained by—		
a. Reviewing the prior years' working papers, permanent file, auditors' report, and statements?	____	____
b. Reviewing any interim financial statements or reports for the current year, including filings with regulatory agencies; or, if such statements or reports have not been prepared, by scanning the general ledger (or trial balance) to determine whether the amounts and relationships appear reasonable in comparison with the prior years?	____	____
c. Reviewing most recent management letters?	____	____
d. Reviewing the client correspondence file?	____	____
e. Obtaining copies of the minutes of meetings of stockholders and the board of directors?	____	____
f. Considering possible impact of nonaudit services rendered to client on the audit?	____	____
2. Have engagement personnel obtained a knowledge of matters that relate to the nature of the entity's business, its organization, and its operating characteristics such as the following:		
a. The type of business?	____	____
b. Types of products and services?	____	____
c. Capital structure?	____	____
d. Related parties?	____	____
e. Locations?	____	____
f. Production?	____	____
g. Distribution methods?	____	____
h. Compensation methods?	____	____
3. Have engagement personnel obtained a knowledge of matters affecting the industry in which the entity operates, such as the following:		
a. Economic conditions?	____	____
b. Government regulations?	____	____
c. Changes in technology?	____	____
d. Accounting practices common to the industry?	____	____
e. Competitive conditions?	____	____
f. Financial trends and ratios?	____	____
4. Have engagement personnel consulted other sources of information that relate to the entity's business, such as the following:		
a. AICPA audit and accounting guides?	____	____
b. Industry publications?	____	____
c. Financial statements of other entities in the industry?	____	____
d. Textbooks, periodicals, and individuals knowledgeable about the industry?	____	____
5. Have methods the entity uses to process accounting information been considered in planning the audit?	____	____
6. Have the following matters been considered in evaluating the effect of the entity's computer processing on the audit of financial statements:		

	Done by	Date
a. The extent to which the computer is used in each significant accounting application?		
b. The complexity of the entity's computer operations, including the use of an outside service center?		
c. The organizational structure of the computer processing activities?		
d. The availability of data?		
e. The use of computer-assisted audit techniques to increase the efficiency of performing audit procedures?		
7. Have engagement personnel considered whether specialized skills are needed to consider the effect of computer processing on the audit?		
.05 E. Assessing Auditability		
1. Has the adequacy of the accounting records been assessed for the following factors:		
a. Are transactions described in sufficient detail to permit appropriate classification in financial statements?		
b. Are transactions described in a manner that permits the recording of monetary value in the financial statements?		
c. Do accounting records include the period in which the transactions occurred to permit the recording of transactions in the appropriate accounting period?		
2. Has an understanding of the design of the relevant policies, procedures, and records, pertaining to the control environment, accounting system, and control procedures of the internal control structure and whether they have been placed in operation been obtained through:		
a. Previous experience with the entity?		
b. Inquiries of appropriate management, supervisory, and staff personnel?		
c. Inspection of entity documents and records?		
d. Observation of entity activities and operations?		
3. Has the understanding of the entity's internal control structure elements obtained to plan the audit been documented?		
4. Have the following procedures been performed regarding the integrity of management:		
a. Inquiries of local attorneys, bankers, and other business leaders as to the client's standing in the business community?		
b. A check of the client's credit rating?		
.06 F. Engagement Letter		
1. Have the following items been included in the engagement letter:		
a. Name of entity (and subsidiaries, if any) and its year end?		
b. Statement(s) to be audited, compiled, or reviewed?		
c. Scope of services, as detailed as necessary—including limitations imposed by the client?		
d. Type of report(s) to be rendered?		
e. Disclaimer of responsibility for detecting fraud (see AAM section 3175)?		
f. Obligations of the client's staff to prepare schedule and statements?		
g. Requirement that accountant read all printed material in which his report appears?		
h. Responsibility for preparation or review of tax returns and subsequent tax examinations?		
i. Fee or method of determining fee?		
j. Frequency of billing and client's obligations for payment, including retainer, if applicable?		
k. Provision for client's acceptance signature and date?		
l. Expression of thanks for being selected as auditors or to perform other services?		

	Done by	Date
m. That, in new engagements, the client should take the responsibility for getting the cooperation of the prior auditor and the successor auditor to communicate with the predecessor auditor prior to accepting the engagement?	______	______
2. Have the following optional items been included in the engagement letter:		
a. Description of particular audit procedure, if requested by client or deemed necessary for protection of the auditor (The detailed audit program should not be made available to client personnel, orally or otherwise)?	______	______
b. Extent and timing of interim auditing?	______	______
c. Name of client's personnel to be contacted during engagement?	______	______
d. Study and evaluation of internal control and report thereon (This would be a special engagement, not part of the normal audit routine)?	______	______
e. Interim contact and cooperation with internal auditor?	______	______
f. List of services specifically excluded?	______	______
g. Acknowledgment by the client of its responsibility for the financial statements (Because auditors of smaller, nonpublic entities often may maintain accounting records, prepare financial statements, and advise management about appropriate accounting principles, such an acknowledgment may be particularly appropriate for such clients.)?	______	______
h. A statement that the client will be informed of any reportable conditions in the internal control structure that come to the auditor's attention during his audit of financial statements (Such a communication, either orally or in writing, is required by SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* [AU section 325].)?	______	______
.07 **G. Assessing Audit Risk and Materiality**		
1. Have inherent and control risk been assessed to determine how much detection risk can be accepted while still restricting audit risk to an acceptably low level?	______	______
2. Has a preliminary judgment about the dollar amount of misstatement that would be material to the financial statements been determined?	______	______
3. Has that amount been related to tolerable error for specific account balances in planning audit procedures?	______	______
.08 **H. Assessment of Control Risk**		
1. If control risk is assessed at the maximum level for some or all financial statement assertions, has that conclusion been documented?	______	______
2. Have the following procedures been performed in assessing control risk at below the maximum level for some or all financial statement assertions:		
a. Identifying specific internal control structure policies and procedures relevant to specific assertions that are likely to prevent or detect material misstatements in those assertions?	______	______
b. Performing tests of controls to evaluate the effectiveness of the design and operation of such policies and procedures?	______	______

	Done by	Date
3. If a further reduction in the assessed level of control risk is desired for some financial statement assertions, have additional tests of relevant controls been performed?	____	____
4. Has the basis for the conclusion that control risk is assessed at below maximum level for some or all financial statement assertions been documented?	____	____

.09 I. **Errors and Irregularities**

	Done by	Date
1. Have the following factors been considered in assessing the risk of material misstatement at the financial statement level:		
a. Management characteristics (e.g., management's attitude toward financial reporting is unduly aggressive)?	____	____
b. Operating and industry characteristics (e.g., profitability of entity relative to its industry is inadequate or inconsistent)?	____	____
c. Engagement characteristics (e.g., significant and unusual related party transactions not in the ordinary course of business are present)?	____	____
2. Have the following factors been considered in assessing the risks of management misrepresentation at the financial statement level:		
a. Are there known circumstances that may indicate a management predisposition to distort financial statements, such as frequent disputes about aggressive application of accounting principles that increase earnings?	____	____
b. Are there indications that management has failed to establish policies and procedures that provide reasonable assurance of reliable accounting estimates, such as personnel who develop estimates appearing to lack necessary knowledge and experience?	____	____
c. Are there conditions that indicate a lack of control of activities, such as constant crisis conditions in operating or accounting areas?	____	____
d. Are there indications of a lack of control over computer processing, such as a lack of controls over access to applications that initiate or control the movement of assets (e.g., a demand-deposit application in a bank)?	____	____
e. Are there indications that management has not developed or communicated adequate policies and procedures for security of data or assets, such as not investigating employees in key positions before hiring?	____	____
3. Have the following factors been considered in assessing the risk of material misstatement at the balance or class level:		
a. Complexity and contentiousness of accounting issues affecting balance or class?	____	____
b. Nature, cause, and amount of known and likely misstatements detected in the balance or class in the prior audit?	____	____
c. Susceptibility of related assets to misappropriation?	____	____
d. Extent of judgment involved in determining the total balance or class?	____	____
4. Has the assessment of risk of material misstatement been considered in determining:		
a. The nature, timing or extent of audit procedures?	____	____
b. Assigning staff?	____	____
c. Requiring appropriate levels of supervision?	____	____
5. If it is determined that significant risk of material misstatement exists:		
a. Have the details of specific transactions involving senior management been identified and confirmed with the appropriate external parties?	____	____

	Done by	Date
b. Have the details of all material accounting entries prepared or approved by senior management been reviewed?	_____	_____
c. Has it been considered whether accounting policies are acceptable in the circumstances?	_____	_____
.10 J. Illegal Acts		
1. Have the following matters been considered in the assessment of risk that the entity has not complied with laws and regulations that have a direct and material effect on the determination of financial statement amounts:		
a. The client's policy, if any, relative to the prevention of illegal acts?	_____	_____
b. Management's understanding of the requirements of laws and regulations pertinent to audit objectives?	_____	_____
c. The nature and extent of noncompliance noted in prior audits?	_____	_____
d. Internal control structure elements designed to give management reasonable assurance that the entity complies with those laws and regulations?	_____	_____
.11 K. Analytical Procedures		
1. Have analytical procedures been used which focus on:		
a. Enhancing the auditor's understanding of the client's business and the transactions and events that have accrued since the last audit date?	_____	_____
b. Identifying areas that may represent specific risks relevant to the audit?	_____	_____
.12 L. Audit Strategies and the Audit Program		
1. Has the proposed audit program been developed for the engagement?	_____	_____
2. Has the final audit program been approved by the engagement partner?	_____	_____

[The next page is 3381.]

AAM Section 3170
Audit Assignment Controls

.01 **Audit Time Budget – Sample A**

Client ______________________ Audit date ______________________

Prepared by ______________________

Approved:
Supervisor __________ Date ______ Partner __________ Date ______

Preliminary work:
Start __________ End __________

Final work:
Start __________ End __________

	Budget (in hours)	
	May to Nov	Dec to April
Cash		
Receivables.		
Confirmation of balances		
Review ledgers, etc.		
Inventories:		
Observation of physical counts		
Price tests, etc.		
Securities and investments		
Property, plant, and equipment		
Accumulated depreciation and amortization		
Other assets		
Notes and accounts payable		
Tax accruals		
Other liabilities		
Capital stock		
Retained earnings		
Other equity accounts		
Income accounts		
Costs and expense accounts		
Current provision for taxes		
Other income and expense accounts		
Minutes, agreements, etc		
Conferences with client		
General supervision and planning		
Review computer programs and auditability		
Review of internal control		
Review and update permanent files		
Travel		
Report and statement review		
Other matters		
Total budgeted hours *(Excludes tax and report departments' time)*		

.02

Audit Time Budget — Sample B

Date	Total hours (Accountant's initials color coded)				General														Cash			Inventories																				Other (describe)		
	Total	Supervisor or manager	Senior	Assistant	Audit program	Prior period reports Working papers etc	Trial balance and adjusting entries	Permanent file	Financial statement comparison	Transactions since balance sheet date	Preparation of reports	Internal control quest. and mgmt. letter	Time summary	Supervision	Correspondence and conferences	Review in-house computer programs	Audit of/with computer	General ledger and journal entries	In banks and on hand	Receipts and disbursements	Notes/accts. rec. and allowance for losses	Observation	Comparison of quantities	Valuation	Clerical accuracy and analytical review	Prepaid expenses	Other current assets	Fixed assets and depreciation	Investments	Other assets	Notes payable and long-term debt	Accounts payable	Other current liabilities	Other long-term liabilities and deferred income	Stockholders equity	Contingent liabilities	Sales and revenue	Payrolls	Other expense and income tests and analyses	Preparation of tax returns			
Budget																																												
Actual																																												

.03

Audit Time Analysis *(Short Form)*

Client Year ended

	Prior years		Budgeted hours											Actual daily hours																					Next year's budget
			Total	Week beginning																														Total	
Administration																																			
Accounting systems review																																			
Confirmations																																			
Permanent file																																			
Client advisory comments																																			
Report preparation																																			
Tax returns																																			
Initial review																																			
Overall review																																			
Detailed review																																			
Tax accrual review																																			
Trial balance																																			
Cash																																			
Receivables																																			
Inventories																																			
Other assets																																			
Liabilities																																			
Equity																																			
Operating accounts																																			
Totals																																			
Accountants																																			
In-Charge																																			
Totals																																			

.04

Audit Time Analysis (Long Form)

Client ______________ Year ended ______________

	Prior Years		Budgeted Hours											Actual Daily Hours																					Next year's budget
			Total	Week beginning																														Total	
Administration																																			
Client conferences																																			
Planning and scheduling																																			
Staff supervision																																			
Accounting systems review																																			
Internal control																																			
EDP installation																																			
General ledger																																			
Cash																																			
Sales																																			
Voucher register																																			
Payroll																																			
Journal entries																																			
Confirmations																																			
Permanent file																																			
Client advisory comments																																			
Report preparation																																			
Financial statements																																			
Footnotes																																			
Tax return preparation																																			
Review																																			
Initial review																																			
Overall review																																			
Detailed review																																			
Tax accrual review																																			
Subtotal to next page																																			

Audit Time Analysis (Long Form) (Continued)

Client ____________ Year ended ____________

	Prior Years		Budgeted Hours											Actual Daily Hours																				Next year's budget
			Total	Week beginning																													Total	
Year-end verification																																		
Trial balance																																		
Cash																																		
Notes receivable																																		
Accounts receivable																																		
Inventories																																		
Prepaid expenses																																		
Intercompany accounts																																		
Securities and investments																																		
Fixed assets																																		
Other assets																																		
Notes payable																																		
Accounts payable																																		
Tax grouping and accrual																																		
Accrued liabilities																																		
Deferred credits																																		
Contingencies and commitments																																		
Equity																																		
Audit of/with computer																																		
Operating accounts																																		
Subtotal from previous page																																		
Totals																																		
Accountants																																		
Manager																																		
In charge																																		
Totals																																		

.05

Weekly Progress Report

Date ____________

Supervisor ____________ In-charge accountant ____________

Client ____________ Case ____________

	Staff days—seven hours				
	Original Estimate	Used to date	Unused	Est to complete	Variance
In-charge accountant					
Assistants *(list)*.					
Total assistants					
Grand total					

[The next page is 3401.]

AAM Section 3175
Sample Engagement Letters

.01 Following are illustrative engagement letters (and one engagement memorandum). They may be used as guides in the design of specific letters, tailored to satisfy the terms of a particular engagement.

.02 Audit Engagement Leading to Opinion

SWIFT, MARCH & COMPANY Certified Public Accountants

[*Date*]
Mr. Thomas Thorp, President
Anonymous Company, Inc.
Route 32
Nowhere, New York 10000

Dear Mr. Thorp:

This will confirm our understanding of the arrangements for our audit of the financial statements of Anonymous Company, Inc., for the year ending [*date*].

We will audit the Company's balance sheet at [*date*], and the related statements of income, retained earnings, and cash flows for the year then ended, for the purpose of expressing an opinion on them. The financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements based on our audit.

We will conduct our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable 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 will provide a reasonable basis for our opinion.

Our procedures will include tests of documentary evidence supporting the transactions recorded in the accounts, tests of the physical existence of inventories, and direct confirmation of receivables and certain other assets and liabilities by correspondence with selected customers, creditors, legal counsel, and banks. At the conclusion of our audit, we will request certain written representations from you about the financial statements and matters related thereto.

Our audit is subject to the inherent risk that material errors and irregularities, including fraud or defalcations, if they exist, will not be detected. However, we will inform you of irregularities that come to our attention, unless they are inconsequential.

If you intend to publish or otherwise reproduce the financial statements and make reference to our firm, you agree to provide us with printers' proofs or masters for our review and approval before printing. You also agree to provide us with a copy of the final reproduced material for our approval before it is distributed.

We will review the Company's federal and state [*identify states*] income tax returns for the fiscal year ended [*date*]. These returns, we understand, will be prepared by the controller.

Further, we will be available during the year to consult with you on the tax effects of any proposed transactions or contemplated changes in business policies.

Our fee for these services will be at our regular per diem rates, plus travel and other out-of-pocket costs. Invoices will be rendered every two weeks and are payable on presentation.

We are pleased to have this opportunity to serve you.

If this letter correctly expresses your understanding, please sign the enclosed copy where indicated and return it to us.*

Very truly yours,

SWIFT, MARCH & COMPANY

....
Partner

APPROVED:

By ....

Date ....

*Some accountants prefer not to obtain an acknowledgment, in which case their letter would omit the paragraph beginning "If this letter . . ." and the spaces for the acknowledgment. The first paragraph of their letter might begin as follows: "This letter sets forth our understanding of the terms and objectives of our audit . . . ."

.03 Audit Engagement Leading to Opinion (Including Financial Information for Form 10-K)

SWIFT, MARCH & COMPANY Certified Public Accountants

[*Date*]

Mr. Frederick Mead, President
Thor Tool Co., Inc.
473 Canyon Road
Noplace, NJ 07000

Dear Mr. Mead:

This letter confirms our arrangements with Thor Tool Co., Inc. for the year ended [*date*].

We will audit the Corporation's balance sheet as of [*date*], and the related statements of income, retained earnings, and cash flows for the year then ended. The financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements based on our audit.

We will conduct our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable 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 will provide a reasonable basis for our opinion.

Our procedures will include tests (by statistical sampling, if feasible) of documentary evidence supporting the transactions recorded in the accounts; tests of the physical existence of inventories, and direct confirmation of receivables and certain other assets and liabilities by correspondence with selected customers, creditors, legal counsel, and banks. At the conclusion of our audit, we will request certain written representations from you about the financial statements and matters related thereto.

Your accounting department personnel will prepare the necessary detailed trial balance and supporting schedules. We will assemble and audit the financial information required for Form 10-K and for the annual report to stockholders. Both must be submitted to us for approval before publication.

Our audit is subject to the inherent risk that material errors and irregularities, including fraud or defalcations, if they exist, will not be detected. However, we will inform you of irregularities that come to our attention, unless they are inconsequential.

If you intend to publish or otherwise reproduce the financial statements and make reference to our firm, you agree to provide us with printers' proofs or masters for our review and approval before printing. You also agree to provide us with a copy of the final reproduced material for our approval before it is distributed.

Fees for these services will be at our standard per diem rates. Invoices, including out-of-pocket expenses, will be submitted every two weeks as the work progresses, and are payable on presentation. We estimate that our fee for this engagement will be between $10,000 and $12,000. Should any situation arise that would materially increase this estimate, we will, of course, advise you.

Please indicate your agreement to these arrangements by signing the attached copy of this letter and returning it to us.*

Sincerely,

SWIFT, MARCH & COMPANY

....
Partner

APPROVED:

By...

Date...

*Some accountants prefer not to obtain an acknowledgment, in which case their letter would omit the paragraph beginning "Please indicate your ..." and the spaces for the acknowledgment. The first paragraph of their letter might begin as follows: "This letter sets forth our understanding of the terms and objectives of our audit ...."

.04 Change in Circumstances From Those Contemplated in Original Engagement Letter

SWIFT, MARCH & COMPANY Certified Public Accountants

[*Date*]
Mr. James Johnson, Treasurer
Birdie Country Club
64 Eagle Road
Noplace, New York 10000

Dear Mr. Johnson:

As we agreed in our original engagement letter dated [*date*] we are notifying you that our audit of your [*date*] financial statements requires additional procedures.

We have found that certain guest checks are held for only three months after they are paid. Thus, a substantial number of guest checks are not available for examination. Fortunately, your internal control structure policies and procedures allows us to use alternative procedures to satisfy ourselves on this part of the audit. However, this will require substantially more time than examining guest checks.

The fee for these additional services will be billed at our standard per diem rates and added to the $X,XXX fee quoted in our previous letter.

The problem has been discussed with your controller, who assured us that in the future all guest checks will be kept for two years.

Please indicate your acceptance of these added terms by signing the copy of this letter and returning it to us. *

Very truly yours,

SWIFT, MARCH & COMPANY

....
Partner

APPROVED:

By..

Date...

* Some accountants prefer not to obtain an acknowledgment, in which case their letter would omit the paragraph beginning "Please indicate your . . ." and the spaces for the acknowledgment. The first paragraph of their letter might begin as follows: "This letter sets forth our understanding of the terms and objectives of our audit . . . ."

.05 Conditions Encountered Which Do Not Permit Expression of Opinion as Anticipated in Original Engagement Letter

SWIFT, MARCH & COMPANY Certified Public Accountants

[*Date*]
Ms. Helene Brown, President
ZYX, Inc.
1234 West Street
Noplace, New York 10000

Dear Ms. Brown:

Our March 15, 19XX letter described our present engagement as an audit for the purpose of expressing an opinion on the company's [*date*] financial statements. This letter is to inform you that because of the circumstances described below, we will be required to qualify our opinion on these statements.

As you know, the Internal Revenue Service has proposed total income tax assessments of approximately $180,000 for the three fiscal years ended [*date*]. Your tax counsel has advised us that although you have a defensible position and will protest the assessments, counsel cannot offer an opinion as to your ultimate liability. No provision for this assessment or any portion of it is included in your [*date*] financial statements, nor do you feel any is necessary. You agreed, however, that the proposed assessment and its present status will be disclosed in the notes to the financial statements.

Because of the uncertainty as to your ultimate liability, we will be unable to express an unqualified opinion. Our report will state that the financial statements are subject to the effects of such adjustments, if any, as might have been required had the outcome of this income tax matter been known.

You and your tax counsel have advised that you will inform us of any new developments in the proposed assessment before our report is issued so that we may consider their effect on your financial statements and on our report.

Very truly yours,

SWIFT, MARCH & COMPANY

....
Partner

NOTE: The client is not asked to sign this letter. Its purpose is to inform him of the altered circumstances and the effect on the opinion. There is no change in the terms of the engagement. However, it might be desirable to have the client acknowledge receipt of this letter by signing a copy and returning it where—for example—it is a problem client, or when there has been a history of misunderstandings.

.06 SEC Engagement: Initial Registration, Form S-1

SWIFT, MARCH & COMPANY Certified Public Accountants

[*Date*]

Mr. John James, President
Odin Company, Inc.
3 Bay Drive
La Mancha, California 99999

Dear Mr. James:

This letter confirms the arrangements for our services for the registration statement Odin Company will file with the Securities and Exchange Commission.

We will audit the consolidated balance sheets of Odin Company, Inc., as at December 31, 19X1 and 19X0, and the related statements of income, retained earnings, and cash flows for the three years then ended, which will be included in a Form S-1,* registration statement. The financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements based on our audit.

We will conduct our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable 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 will provide a reasonable basis for our opinion. We will also audit the financial information necessary for the schedules required by Regulation S-X of the SEC.

We will perform these services as expeditiously as possible. Your accounting personnel will assist us and cooperate in the timely preparation of trial balances, schedules and account analyses, and provide clerical assistance as needed. Mr. John Brown of the law firm of Green & Brown will be liaison with counsel.

If during our audit we find that we are unable to express an unqualified opinion on the financial statements or that we are otherwise unable to comply with the requirements of Form S-1, we will notify you of the problems encountered.

We will also fulfill the portion of the underwriter's agreement directed to the independent accountants, provided the requirements are within the purview of Statement on Auditing Standards No. 49 (*Letters for Underwriters*), issued by the American Institute of Certified Public Accountants, and provided the material can properly be reported on by accountants pursuant to that Statement. In this regard, we require that a copy of the tentative underwriting contract be given us as soon as it is available. Should that portion of the underwriting contract that deals with the details of the comfort letter be available before the balance of the underwriting contract is completely drafted, you will arrange for us to receive a copy of it.

Subsequent to issuance of our auditor's report, we will perform certain procedures required by Statement on Auditing Standards No. 37 (*Filings Under Federal Securities Statutes*), issued by the American Institute of Certified Public Accountants, regarding execution of consent letters required for certain SEC filings. In connection therewith, all printer's proofs of reports to be filed with the Securities and Exchange Commission are to be submitted to us for review. This requirement extends to the entire registration statement and all other material which accompanies the financial statements.

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* This should be edited to agree with the particular form to be filed.

Our audit is subject to the inherent risk that material errors and irregularities, including fraud or defalcations, if they exist, will not be detected. However, we will inform you of irregularities that come to our attention, unless they are inconsequential.

Our fee for services will be computed at our standard per diem rates, and will be billed to you, together with out-of-pocket costs, every two weeks. Invoices are due and payable on presentation. Before our services begin, you have agreed to pay us a $XX,XXX retainer, which will be applied to the final billing for this engagement.

We appreciate your confidence in our firm by retaining us as your independent certified public accountants.

If this letter correctly expresses your understanding, please sign the enclosed copy where indicated and return it to us, together with your check for $XX,XXX.

Sincerely,

SWIFT, MARCH & COMPANY

....

Partner

APPROVED:

By..

Date..

.07 Compilation of Financial Statements and Tax Services

SWIFT, MARCH & COMPANY Certified Public Accountants

[*Date*]
Mr. Tom Jones, President
ZYXWV Freight Corporation
648 Crystal Lane
Noplace, Anystate 00000

Dear Mr. Jones:

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

We will perform the following services:

1. We will compile, from information you provide, the annual and interim balance sheets and related statements of income, retained earnings, and cash flows of ZYXWV Freight Corporation for the year 19XX. We will not audit or review such financial statements. Our report on the annual financial statements of ZYXWV Freight Corporation is presently expected to read as follows:

   > We have compiled the accompanying balance sheet of XYZ Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.
   >
   > A compilation is limited to presenting in the form of financial statements information that is the representation of management (owners). 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.

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

   > Management has elected to omit substantially all of the disclosures 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.

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

2. We will assist your bookkeeper in adjusting the books of account so that he will be able to prepare a working trial balance from which financial statements can be compiled. Your bookkeeper will provide us with a detailed trial balance and any supporting schedules we require.

3. We will also prepare the federal and state [*identify states*] income tax returns for ZYXWV Freight Corporation for the fiscal year ended December 31, 19XX.

Our engagement cannot be relied upon to disclose errors and irregularities, including fraud or defalcations, that may exist. However, we will inform the appropriate level of management of any material errors that come to our attention and any irregularities or illegal acts that come to our attention, unless they are inconsequential.

Our fees for these services . . . .

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

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

Sincerely yours,

....
Swift, March & Company

Acknowledge:

ZYXWV Freight Corporation

....
President

....
Date

* Some accountants prefer not to obtain an acknowledgment, in which case their letter would omit the paragraph beginning "If the foregoing . . ." and the spaces for the acknowledgment. The first paragraph of their letter might begin as follows: "This letter sets forth our understanding of the terms and objectives of our engagement. . . ."

.08 Review of Financial Statements and Tax Services

SWIFT, MARCH & COMPANY Certified Public Accountants

[*Date*]
Mr. Tom Jones, President
ZYXWV Freight Company
648 Crystal Lane
Nowhere, Anystate 00000

Dear Mr. Jones:

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

We will perform the following services:

1. We will review the balance sheet of ZYXWV Freight Company as of [*date*], 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. We will not perform an audit of such financial statements taken as a whole, and, accordingly, we do not express an opinion on them. A review does not contemplate obtaining an understanding of the internal control structure or assessing control risk, tests of accounting records and responses to inquiries by obtaining corroborating evidential matter, and certain other procedures ordinarily performed during an audit. Thus, a review does not provide assurance that we will become aware of all significant matters that would be disclosed in an audit. Our engagement cannot be relied upon to disclose errors, irregularities, or illegal acts, including fraud or defalcations, that may exist. However, we will inform the appropriate level of management of any material errors that come to our attention and any irregularities or illegal acts that come to our attention, unless they are inconsequential.

Our report is presently expected to read as follows:

> We have reviewed the accompanying balance sheet of ZYXWV Freight Company as of [*date*], and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management of ZYXWV Freight Company.
>
> A review consists principally of inquiries of Company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.
>
> Based on our review, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.

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

2. We will provide your chief accountant with such consultation on accounting matters as he may require in adjusting and closing the books of account and in drafting financial statements for our review. Your chief accountant also will provide us with a detailed trial balance and any supporting schedules we require.

3. We will also prepare the federal and state [*identify states*] income tax returns for ZYXWV Freight Company for the fiscal year ended [*date*].

Our fees for these services. . .

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

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

Sincerely yours,

....
[*Signature of accountant*]

Acknowledged:

ZYX WV Freight Company

....
President

....
Date

* Some accountants prefer not to obtain an acknowledgement, in which case their letter would omit the paragraph beginning "If the foregoing . . ." and the spaces for the acknowledgement. The first paragraph of their letter might begin as follows: "This letter sets forth our understanding of the terms and objectives of our engagement. . . ."

.09 Sample Engagement Memorandum (When No Formal Engagement Letter Is Sent)

Engagement Memorandum

[*Date*]

Client	ABC, Inc.
Address	711 Easy Street, La Mancha, Calif. 99999
Phone	QUincy 7-1234
Final arrangements made with	Oscar Brown, President
Date final arrangements made	February 15, 19XX at a meeting in the ABC offices
Client's personnel responsible for accounting matters	Tom Smith, Treasurer
	Joe Green, Controller
Responsibilities of client's personnel in preparation for engagement	Trial balance of G/L and completion of schedules, a list of which we will submit two weeks before beginning of engagement
Reports to be addressed to	Board of Directors (twelve copies)
Financial statements to be audited	Balance sheet at March 31, 19XX and statements of income, retained earnings, shareholders' equity and cash flows for year ended March 31, 19XX
Nature of engagement	Opinion audit and federal and state income tax returns for year ended March 31, 19XX
Date audit to commence	Approximately April 24, 19XX (check with controller about April 10)
Estimated time required	About three weeks
Staff requirements	Manager, supervisor, an in-charge senior, and two staff assistants
Billing arrangements	Every two weeks, at standard plus out-of-pocket costs; invoices to attention of Tom Smith; payable on presentation
Special accounting problems	Client was involved in a substantial sale and leaseback transaction during the year
	Imputed interest may be required on long-term liabilities resulting from purchase of business
Other comments	Client is presently negotiating with machinists union

.10 Audit of Personal Financial Statements

[Salutation]

This letter is to confirm our understanding of the terms and objectives of our audit and the nature and limitations of the services we will provide.

We will perform the following service(s):

1. We will audit the statement of financial condition of James and Jane Person as of *[date]*, and the related statement of changes in net worth for the *[period]* then ended, for the purpose of expressing an opinion on them. The financial statements are the responsibility of James and Jane Person. Our responsibility is to express an opinion on the financial statements based on our audit. We will conduct our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amount and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by James and Jane Person, as well as evaluating the overall financial statement presentation.

   [Standard Audit Report]

2. We will also *[discussion of other services, if any]*.

Our audit is subject to the risk that material errors and irregularities, including fraud or defalcations, if they exist, will not be detected. However, we will inform you of material errors that come to our attention, and any irregularities or illegal acts that come to our attention, unless they are clearly inconsequential.

Our fees for these services *[specify fees or terms]*.

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

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

Sincerely yours,

____
[Signature of accountant]

Acknowledged:

____

____

____
[Date]

[Source: AICPA *Personal Financial Statements Guide.*]

.11 Compilation of Personal Financial Statements

[*Salutation*]

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

We will perform the following service(s):

1. We will compile, from information you provide, the statement of financial condition of James and Jane Person as of [*date*], and the related statement of changes in net worth for the [*period*] then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Our review will consist primarily of inquiries of company personnel and analytical procedures, and we will require a client representation letter from you. We will not audit or review such financial statements. Our report on the financial statements is presently expected to read as follows:

   [*Standard Compilation Report*]

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

2. We will also [*discussion of other services, if any*].

Our engagement cannot be relied upon to disclose errors and irregularities, including fraud or defalcations, that might exist. However, we will inform the appropriate level of management of any material errors that come to our attention and any irregularities or illegal acts that come to our attention, unless they are clearly inconsequential.

Our fees for these services [*specify fees or terms*].

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

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

Sincerely yours,

____
[*Signature of accountant*]

Acknowledged:

____

____

____
[*Date*]

[Source: AICPA *Personal Financial Statements Guide*.]

.12 Review of Personal Financial Statements

[*Salutation*]

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

We will perform the following service(s):

1. We will review the statement of financial condition of James and Jane Person as of [*date*], and the related statement of changes in net worth for the [*period*] then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Our review will consist primarily of inquiries of company personnel and analytical procedures, and we will require a client representation letter from you. We will not perform an audit of such financial statements, the objective of which is the expression of an opinion regarding the financial statements taken as a whole, and, accordingly, we will not express such an opinion on them. Our report on the financial statements is presently expected to read as follows:

   [*Standard Review Report*]

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

2. We will also [*discussion of other services, if any*].

Our engagement cannot be relied upon to disclose errors and irregularities, including fraud or defalcations, that might exist. However, we will inform the appropriate level of management of any material errors that come to our attention and any irregularities or illegal acts that come to our attention, unless they are clearly inconsequential.

Our fees for these services [*specify fees or terms*].

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

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

Sincerely yours,

____
[*Signature of accountant*]

Acknowledged:

____
____
____
[*Date*]

[Source: AICPA *Personal Financial Statements Guide.*]

[The next page is 4001.]

AAM Section 4000

INTERNAL CONTROL STRUCTURE

The material included in these sections on internal control structure is presented for illustrative purposes only. The comments and illustrations are neither all inclusive nor are they prescribed minimums. They are intended as conveniences for users of this manual who may want assistance when developing materials to meet their individual needs.

This manual is a nonauthoritative kit of practice aids and, accordingly, these sections on internal control structure do not include extensive explanation or discussion of authoritative pronouncements. Users of this manual are urged to refer directly to applicable authoritative pronouncements when appropriate.

TABLE OF CONTENTS

Section *Paragraph*

[The next page is 4101.]

AAM Section 4100
Introduction

.01 The second standard of field work states, "A sufficient understanding of the internal control structure is to be obtained to plan the audit and to determine the nature, timing and extent of tests to be performed." SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AU section 319), indicates that the auditor should have an understanding of the control environment, the accounting system, and control procedures, i.e., the internal control structure. After the auditor obtains this understanding, he may decide to assess control risk at the maximum level. Where the assessed level of control risk is the maximum, only that conclusion need be documented. However the auditor must still document his or her understanding of the internal control structure.

.02 SAS No. 55 includes discussion of the subdivision of internal control structure into the control environment, the accounting system, and control procedures, and states that," . . . Dividing the internal control structure into these three elements facilitates discussion of its nature and how the auditor considers it in an audit. The auditor's primary consideration, however, is whether an internal control structure policy or procedure affects financial statement assertions rather than its classification into any particular category." (SAS No. 55, paragraph 8 [AU section 319.08]). Accordingly, the term "internal control structure" is used throughout these sections.

.03 The following Statements on Auditing Standards provide authoritative interpretation of the second standard of field work:

SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AU section 319).

SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* (AU section 325).

.04 Statement on Standards for Attestation Engagements No. 2, *Reporting on an Entity's Internal Control Structure Over Financial Reporting* (AT section 400), provides guidance to the practitioner who is engaged to examine and report on management's assertion about the effectiveness of an entity's internal control structure over financial reporting.

.05 These sections include comments on practice aids used in obtaining an understanding of the internal control structure and assessing control risk, including illustrative examples of the following:

Internal control structure inquiries—small business.

Specific internal control structure objectives and related questions—medium to large business.

Internal control structure flowcharts—small business.

[The next page is 4201.]

AAM Section 4200
General Approach

.01 The auditor usually starts obtaining or updating his understanding of the client's internal control structure policies and procedures relevant to the audit of the financial statements at the beginning of field work. This timing is important because the auditor uses this current understanding in determining the nature, timing, and extent of tests of controls and substantive tests to be performed during the audit. During preliminary meetings with the client, before commencing field work, the auditor may make inquiries about the client's internal control structure policies and procedures relevant to the audit or about significant changes therein.

.02 The auditor's understanding of the internal control structure in all audits should include knowledge of each of the three elements: control environment, accounting system, and control procedures. The auditor is required to obtain a sufficient understanding of each of the three elements to plan the audit. The auditor should perform procedures to understand the design of relevant policies and procedures and whether they have been placed in operation. Generally, the policies and procedures relevant to an audit pertain to the entity's ability to record, process, summarize, and report financial data consistent with the assertions embodied in the financial statements. The auditor is not required to, but may, obtain knowledge about the operating effectiveness of relevant policies and procedures as part of the understanding of internal control structure.

.03 The control environment represents the collective effect of various factors on establishing, enhancing, or mitigating the effectiveness of specific policies and procedures. Such factors include the following:

1. Management's philosophy and operating style.
2. The entity's organizational structure.
3. The functioning of the board of directors and its committees, particularly the audit committee.
4. Methods of assigning authority and responsibility.
5. Management's control methods for monitoring and following up on performance, including internal auditing.
6. Personnel policies and practices.
7. Various external influences that affect an entity's operations and practices.

.04 The control environment reflects the overall attitude, awareness, and actions of the board of directors, management, owners, and others concerning the importance of control and its emphasis in the entity.

.05 The accounting system consists of 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 gives appropriate consideration to establishing records and methods that will:

1. Identify and record all valid transactions.
2. Describe on a timely basis the transactions in sufficient detail to permit proper classification of transactions for financial reporting.
3. Measure the value of transactions in a manner that permits recording their proper monetary value in the financial statements.

4. Determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period.

5. Present properly the transactions and related disclosures in the financial statements.

.06 Control procedures are those policies and procedures in addition to the control environment and accounting system that management has established to provide reasonable assurance that specific entity objectives will be achieved. Control procedures have various objectives and are applied at various organizational and data processing levels. They may also be integrated into specific components of the control environment and the accounting system. Generally, they may be categorized as procedures that pertain to:

1. Proper authorization of transactions and activities.

2. Segregation of duties that 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 duties—assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets.

3. Design and use of adequate documents and records to help ensure the proper recording of transactions and events, such as monitoring the use of prenumbered shipping documents.

4. 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.

5. Independent checks on performance and proper valuation of recorded amounts, such as clerical checks, reconciliations, comparison 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.

.07 The purpose of obtaining an understanding of the internal control structure is to provide the auditor with adequate knowledge to identify the types of potential misstatements that could occur in account balances or classes of transactions and the related assertions, to consider the factors that affect the risk of material misstatement in such balances or classes, and in turn, to design appropriate tests of controls and substantive tests.

.08 Ordinarily the auditor obtains an understanding by a combination of previous experience with the entity, inquiry, inspection of documents and records, observation, and reference to prior year working papers, client prepared descriptions of the structure, or other appropriate documentation. In determining the nature and extent of procedures to obtain the understanding of each internal control structure element sufficient to plan the audit, the auditor also considers previous experience with the entity, as well as the understanding of the industry in which the entity operates, assessments of inherent risk, judgments about materiality, and the complexity and sophistication of the entity's operations. The auditor must document his understanding of the internal control structure. The extent of the auditor's documentation is directly related to the complexity of the entity's internal control structure. For example, in a large entity with a complex structure, the auditor may use questionnaires and flowcharts to obtain and document the necessary understanding. In a small, owner managed entity with a simple internal control structure, a narrative memorandum may be sufficient documentation.

.09 After documenting his understanding of the internal control structure, the auditor assesses control risk for financial statement assertions. Control risk is the risk that a material misstatement that could occur in an assertion will not be prevented or timely detected by the internal control structure. The auditor assesses control risk by evaluating the design and operating effectiveness of the policies and procedures in the control environment, accounting system, and control procedures established to prevent or timely detect misstatements. The conclusion derived from assessing control risk is called the "assessed level of control risk." The level may vary from maximum to minimum and may be stated in either quantitative (e.g., on a "scale" or percentages) or qualitative (high, moderate, or low). The assessed level of control risk is determined by two factors:

1. The presence of (or lack of) internal control structure policies and procedures that are relevant to a financial statement assertion and

2. The extent to which the design and operation of those policies or procedures are effective in preventing or detecting misstatements in the assertion.

.10 At this point, the auditor may decide to assess control risk at maximum for some or all assertions because policies or procedures are not relevant to the assertions or they are unlikely to be effective. Even when potentially effective policies and procedures exist, the auditor may decide that testing their effectiveness would be inefficient (i.e. the increase in audit effort for tests of controls may outweigh the decrease in audit effort from reduced substantive testing). In such circumstances, the auditor would decide to assess control risk for these assertions at maximum level. Control risk would also be assessed at maximum when the auditor obtains evidence that policies and procedures relevant to an assertion aren't suitably designed or operating effectively.

.11 When control risk is assessed below the maximum level, the auditor should identify internal control structure policies or procedures relevant to the assertion and perform tests of controls. Tests of controls include procedures such as inquiry, observation, and reperforming procedures by the auditor. The resulting evidence is used to assess whether control risk for the assertion is below the maximum level. The auditor considers two potential sources of evidence about the effectiveness of the design and operation of internal control structure policies and procedures:

1. The understanding of the internal control structure and

2. Any planned tests of controls performed concurrently with obtaining the understanding.

.12 The understanding of the internal control structure may provide evidence to support an assessment of control risk at below the maximum level because certain procedures performed to obtain the understanding may provide evidence about the effectiveness of design or operation for some policies or procedures even though they weren't specifically planned to do so. This evidence may be sufficient to support an assessed level of control risk below the maximum level. It is important to note that the procedures performed in obtaining the understanding must provide sufficient evidence to evaluate the effectiveness of both the design and operation of internal control structure policies or procedures. An assessment of control risk below maximum cannot be supported unless such sufficient evidence is provided. After assessing control risk using evidence provided by the understanding of the internal control structure and planned tests of controls, the auditor may believe that a further reduction in control risk for some assertions could be supported by obtaining additional evidence. The auditor would perform additional tests of controls if doing so would increase audit efficiency.

.13 When the assessed level of control risk is below maximum, the auditor should document the basis for the assessed level of control risk. This documentation generally includes tests of controls applied to internal control structure policies or procedures. When control risk is assessed at the maximum, only the conclusion itself needs to be documented.

.14 The process of obtaining an understanding of the internal control structure and assessing the level of control risk provides the auditor with a basis for determining the nature, timing, and extent of substantive tests necessary to complete the audit. This may also be an appropriate time to communicate reportable conditions and other internal control structure related matters to the audit committee (or its equivalent).

Aids Used in Obtaining an Understanding of Internal Control Structure and Assessing Control Risk

.15 The auditor may document his understanding of the internal control structure in the form of answers to a questionnaire, narrative memoranda, flowcharts, decision tables, a combination of these forms or any other form that suits the auditor's needs or preferences. Some auditors have preferences for a particular form such as flowcharts and require the form as a matter of firm policy.

.16 Auditors may find aids such as questionnaires, checklists, instructions or similar generalized materials to be useful tools in assessing control risk. These aids generally present questions or statements about internal control structure objectives and specific policies or procedures. These aids also generally include caveats that the auditor must use professional judgment in applying them in actual circumstances (including recognition of when to modify their content and when to prepare or obtain supplementary material).

.17 Some auditors design the aid to serve as a working paper when properly annotated. This type of aid is generally in checklist or questionnaire form. Others design the aid as a reference document with explicit instructions that it is intended for reference purposes and not to be annotated for use as a working paper document. Auditors who incorporate checklists or questionnaires into their working papers believe that they provide efficiency and evidence that certain predetermined matters were considered. Auditors who use reference type aids rather than aids designed to be annotated and retained in the working papers are concerned that standardized checklists may be prepared by rote. Both approaches require that the auditor use professional judgment in the circumstances. Both approaches also require that the auditor remain alert to any matters that may not be covered in the checklists or reference material.

Organization of Checklists, Questionnaires, and Other Generalized Aids

.18 Checklist questionnaires and other generalized aids on internal control structure elements typically present numerous questions, statements, or a combination of both, about specific internal control structure, policies and procedures. Auditors differ in how they structure their materials on internal control structure. Some auditors group their material into balance sheet and related income statement classifications to ease cross-reference with sections of their working papers on substantive tests. Other auditors organize their material into broad transaction cycles. For example, purchases and accounts payable, payrolls, accrued expenses, and cash disbursements may be grouped as an expenditures cycle. This approach transcends the differences in how companies are organized and helps to get an overview of all the effects of transactions across various functional lines within a company. Other auditors organize their material by functions within a company. Examples are requisitioning, purchasing, receiving, invoice processing, accounts payable recording, and payment functions which may be grouped as purchases and payables. This approach follows the established organizational lines in a company and aids in determining who is responsible for performance of prescribed internal control structure procedures. These approaches are conceptual notions and may be applied to large or small organizations. The decision to organize internal control structure material on the statement classification approach, cycle approach, business function approach, or any other suitable approach rests with the individual auditor or firm. Following are some further illustrations of these grouping approaches:

- Related Balance Sheet and Income Statement Classifications: (1) general; (2) cash receipts, disbursements, and balances; (3) accounts receivable and sales; (4) inventory and cost of sales; (5) property, plant and equipment, and related depreciation; (6) investments; (7) accounts payable and purchases; (8) payroll; (9) debt; and (10) equity capital.
- Transaction Cycles: (1) revenue (customer acceptance, credit, shipping, sales, cash receipts, receivables, allowances for doubtful accounts, sales warranties, etc.); (2) expenditures (purchases, payrolls, cash disbursements, accounts payable, accrued expenses, etc.); (3) production or conversion (inventory, cost of sales, property and related depreciation, etc.); (4) financing (investments, debt, leases, equity capital); and (5) financial reporting.[1]
- Groupings of Business Functions: (1) financial reporting (controllership, general accounting); (2) EDP; (3) financial management (cash receipts and disbursements, cash balances and investments, debt, leases, and equity capital); (4) sales and credit (order entry, credit, shipping, billing, receivables and collections); (5) inventory and production costs (production planning and operations, cost accounting, inventory

[1] The financial reporting cycle would include general accounting and preparation of such reports as financial statements, tax returns, and reports to regulatory bodies. For nonpublic companies which work closely with their auditors in preparing such reports, review of internal control structure for the financial reporting cycle may be a moot point.

recordkeeping, and inventory custody); (6) productive assets (planning and authorization for capital assets, accounting for property and related depreciation, maintenance, and asset custody); (7) purchases and payables (purchasing, receiving, invoice processing, and disbursements); and (8) employee compensation and benefits (personnel, employee supervision, payroll preparation and recording, and disbursements).

Formats of Checklists and Questionnaires

.19 Checklist questions are usually worded so a "yes" answer indicates that the client uses a particular policy or procedure. "No" answers serve as signals that the client's internal control structure may have a potential reportable condition unless the client has other policies or procedures that accomplish the same objectives as would the absent procedure. "No" answers pose an especially important documentation problem because they require consideration of the following:

- Should the absent procedure be dismissed as not applicable because it is not relevant in the client's circumstances?
- Does the client have other policies or procedures that accomplish the objective of the absent procedure so that the answer does not indicate a potential reportable condition?
- Does the deficiency require modification of the audit program for substantive tests or are the tests adequate despite the deficiency?
- Is the deficiency a reportable condition requiring communication in accordance with SAS No. 60 (AU section 325)?
- How should other deficiencies be communicated to the client?

.20 Because of these considerations, the formats of questionnaires usually call for information in addition to simply checking yes and no answers. Some questionnaires provide an additional column for "not applicable" and a wide column for additional comment on conclusions about other compensating policies and procedures and the needs for program modifications and/or written communication to the client.

.21 Some questionnaire formats provide additional columns for information such as the following:

- Name of client's employee or group of employees who perform the procedure.
- Specific cross-reference to flowcharts and/or narratives included in the auditor's working papers.
- Specific cross-reference to working papers on tests of controls.
- Specific cross-reference to compensating policies and procedures for absent items; compensating policies and procedures may be represented by other checklist items or noted in complementary memoranda or procedures not anticipated in the questionnaire.
- Specific cross-reference to memoranda on internal control structure deficiencies and their effect on the audit program and development of management letter comments.

.22 Some questionnaires provide for the auditor to initial and date each item. Others provide entry of the date and auditor's signature after each group of questions for a particular transaction cycle or functional grouping. Some questionnaires also include blank formats with preprinted captions on which the auditor may prepare annotations about specific internal control structure deficiencies, conclusions about findings, and proposed amendments (if any) to the audit program. These preprinted captions for example, may include the following:

- Explanation of a specific deficiency or new strength (generally cross-referenced to a specific item in the body of the checklist).
- Cross-reference to a specific compensating internal control structure policy or procedure, if any.

- Whether amendment of the audit program is needed concerning:
  - (a) Further restriction of audit procedures.
  - (b) Extension of audit procedures.
  - (c) Modification of the extent or timing of audit procedures.

Reporting on the Internal Control Structure

.23 In April 1988, the AICPA Auditing Standards Board issued SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit.* This statement requires communication to the client's audit committee or its equivalent material internal control structure weaknesses and other reportable conditions. This communication can be either written or oral. (If oral, the communication should be documented in the working papers.)

.24 The Statement defines a reportable condition as a significant deficiency in the design or operation of the internal control structure which could adversely affect the organization's ability to record, process, summarize and report financial data in the financial statements. These conditions are observed by the auditor during the audit of financial statements, such as when obtaining an understanding of the internal control structure as required by SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit.*

.25 Although SAS No. 60 does not require the auditor to separately identify and communicate material weaknesses that are not reportable conditions, he or she may choose to do so.

.26 In May 1993, the AICPA Auditing Standards Board issued Statement on Standards for Attestation Engagements (SSAE) No. 2, *Reporting on an Entity's Internal Control Structure Over Financial Reporting.* This Statement supersedes SAS No. 30, *Reporting on Internal Accounting Control.*

.27 The SSAE was issued because Congress and other regulatory agencies (such as the Federal Deposit Insurance Corporation, U.S. Department of Housing and Urban Development, Office of Management & Budget) have given internal control heightened political urgency by enacting requirements that management report on the effectiveness of the internal control structure over financial reporting. Another reason for the issuance of this SSAE was to update the concepts included in SAS No. 30 for the new concepts addressed in SAS No. 55 and the attestation standards. For instance, SAS No. 55 introduced a definition of internal control and related concepts that differed from those in SAS No. 30 and the attestation standards introduced performance and reporting concepts applicable to SAS No. 30 engagements that were inconsistent with SAS No. 30 standards.

.28 This Statement provides guidance to practitioners who are engaged to examine and report on management's written assertions about the internal control structure's effectiveness. A practitioner is prohibited from performing a review of management's assertions, an examination must be performed, and a practitioner may not report on the effectiveness of the internal control structure unless:

a. There is a written assertion prepared by management,

b. Management is sufficiently knowledgeable about the internal control structure,

c. Management evaluates the effectiveness of the entity's internal control structure using a reasonable criteria established by a recognized body,[2] and

d. Sufficient evidential matter exists to support management's assertion.

[2] Criteria issued by the AICPA, regulatory agencies, and other bodies composed of experts that follow due process procedures, including procedures for broad distribution of proposed criteria for public comments, usually should be considered reasonable criteria for this purpose. For example, the Committee of Sponsoring Organizations (COSO) of the Treadway Commission's report, "Internal Control Integrated Framework," provides reasonable criteria against which management may evaluate and report on the effectiveness of the entity's internal control structure.

.29 As stated above, for a practitioner to accept an engagement to report on an entity's internal control structure, management must present its written assertion about the effectiveness of the internal control. This assertion may be in a separate report that accompanies the practitioner's report or the assertion may be in a representation letter to the practitioner. In the latter case, however, the practitioner must restrict his or her report.

.30 The Statement also addresses the procedures involved to perform an examination of management's assertions about the effectiveness of an entity's internal control structure. These procedures are:

a. Plan the engagement,

b. Obtain an understanding of the internal control structure,

c. Evaluate the design effectiveness of the internal control structure policies and procedures,

d. Test and evaluate the operating effectiveness of the internal control structure policies and procedures,

e. Obtain a representation letter from management, and

f. Form an opinion about whether management's assertion regarding the effectiveness of the entity's internal control structure is fairly stated, in all material respects, based on the control criteria.

.31 The form of the practitioner's report on the examination of the internal control structure effectiveness is dependent on the manner in which management presents its written assertions. As explained in AAM section 4200.29, the report will either be considered appropriate for general distribution or it should be restricted.

.32 The report should also be modified for the following situations:

a. A material weakness exists

    (1) If management reports a material weakness in its assertion, the practitioner should both modify the opinion paragraph by including a reference to the material weakness and add an explanatory paragraph to the report (see AAM section 10,250.030)

    (2) If management does not report a material weakness, an adverse opinion on management's assertion should be issued (see AAM section 10,250.040)

b. There is a scope limitation (see AAM sections 10,250.050 and 10,250.060)

c. The accountant refers to another accountant's report (see AAM section 10,250.070)

d. A subsequent event occurs

e. The written assertion is for only a segment of the entity (see AAM section 10,250.080)

f. The written assertion addresses only the suitability of the design of the internal control structure not its effectiveness (see AAM section 10,250.090)

g. The assertion is based upon criteria established by a regulatory agency that does not follow due process (see AAM section 10,250.110).

[The next page is 4227.]

AAM Section 4250

Internal Control Structure Considerations in a Minicomputer Environment

.010 The use of minicomputers to process accounting applications has become increasingly common in entities of all sizes. In a minicomputer environment, as elsewhere, the auditor studies the internal control structure, which includes both the EDP and non-EDP features of the minicomputer system. In 1981, AICPA published "Audit and Control Considerations in a Minicomputer or Small Business Computer Environment" as part of its Computer Services Guidelines. That document discusses, among other things, audit and planning considerations, substantive audit techniques, and computer-assisted audit techniques in a minicomputer environment. It may be helpful to auditors who wish to acquire more knowledge about the effect of the use of a minicomputer on the audit plan.

.020 "Audit and Control Considerations in a Minicomputer or Small Business Computer Environment" includes a table that lists the risks and relevant control policies and procedures associated with characteristics frequently found in a minicomputer environment. That table is reproduced below as an aid to auditors assessing control risk in a minicomputer environment.

.030 Lack of Segregation of Functions Between the EDP Department and Users

(Personnel in the user department initiate and authorize source documents, enter data into the system, operate the computer, and use the output reports.)

Risks

Perpetration and concealment of errors or irregularities.

Unauthorized changes to master files.

Inaccurate and incomplete processing of data.

Processing errors.

Incomplete or erroneous data.

Uncorrected errors.

Lost, added, or altered data.

Relevant Control Policies and Procedures

Maintenance of transaction logs and batch controls by user department.

Independent review of processing logs, transaction logs, and batch control information.

Management supervision.

Passwords to control access to files and libraries.

Required vacations and rotation of duties.

Reconciliation of record counts or hash totals.

Use of application programs to make changes in master files.

Independent reconciliation of transaction totals recorded in batch control logs with input and output totals.

Comparison of system manufacturer's utility program with authorized application version.

.040 Location of the Computer

(The computer is located in the same area as the user department.)

Risks

Improper use or manipulation of data files.

Unauthorized use or modification of computer programs.

Improper use of computer resources.

Relevant Control Policies and Procedures

Menus and procedures to control processing access.

Management review of usage reports (history logs).

Periodic comparison of usage reports with processing schedule.

Physical control over data entry devices.

.050 Lack of Segregation of Functions Within the EDP Department

(There is no segregation between programmers and operators.)

Risks

Unauthorized access to information and programs.

Perpetration and concealment of errors or irregularities.

Errors caused by improper use or manipulation of data files or unauthorized or incorrect use of computer program.

Application programs that do not meet management's objectives.

Relevant Control Policies and Procedures

Use of a compiler to convert the source code into object code.

Comparison of library directories with manual records.

Comparison of program in use with an authorized version.

Use of interpretive language programs.

Passwords to control access to libraries and files.

Software controls to limit system access capabilities according to employee function.

Test libraries.

Management review of usage reports (history logs).

Systems of transaction logs, batch controls, processing logs and run-to-run controls.

.060 Limited Knowledge of EDP

(Supervisor responsible for data processing has limited knowledge of EDP.)

Risks

Failure of systems to meet management objectives or operate according to management specifications.

Lack of adequate application controls.

Inadequate testing and review of systems.

Relevant Control Policies and Procedures

Operations documentation.

Program documentation.

Systems documentation.

Use of third party to review new and modified programs and systems.

.070 Utility Programs

(Utility programs are used extensively to enter and to change data.)

Risks

Unauthorized access and changes to data.

Undetected errors in file manipulation.

Lack of adequate application controls.

Processing of unauthorized transactions and omitting of authorized transactions.

Perpetration and concealment of errors or irregularities.

Relevant Control Policies and Procedures

Use of passwords to control access to data files.

Use of application programs to update files.

Independent control over transaction and master file changes, such as item count, control total, and hash totals.

Limited access to utilities.

Removal of utilities from system when practical to do so.

.080 Diskettes

(Diskettes are used extensively for file storage.)

Risks

Processing of the wrong file.

Inability to detect errors in file changes.

Inability to highlight operator errors.

Relevant Control Policies and Procedures

Control over access to diskettes.

Storage of data in format not readable by key entry devices.

Use of manual logs to control diskette library.

.090 Terminals

(Terminals are used for transaction data entry, inquiry, and other interactive functions.)

Risks

Unauthorized input.

Erroneous or fraudulent data.

Errors caused by improper use or manipulation of data files or computer programs.

Erroneous or incomplete data.

Relevant Control Policies and Procedures

Use of software that will allow only certain terminals to be used for specific functions.

Use of physical controls to limit access to data files.

Use of passwords to control access to data files.

Encryption of data and programs.

On-line computer edit procedures.

Record counts, batch controls, run-to-run controls, verification.

Error handling control procedure and error logs.

Use of menus and procedures.

.100 Software Packages

(Purchased software packages are used extensively rather than internally developed application software.)

Risks

Failure of systems to meet management and user objectives.

Lack of adequate applicator controls.

Inadequate testing of systems.

Relevant Control Policies and Procedures

Use of third party to review and evaluate proposed software packages.

.110 Documentation

(Available system program, operator, and user documentation may be limited or nonexistent.)

Risks

Undetected errors during processing and system maintenance.

Relevant Control Policies and Procedures

User-based controls.

[The next page is 4301.]

AAM Section 4300

Illustrative Internal Control Structure Questions—Small Business

.010 The following is a list of illustrative internal control structure questions an auditor might raise concerning a small manufacturing operation owned by one person who also serves as the general manager and has only a few employees involved in the accounting function. These illustrative questions are numbered merely for organization purposes; the numbers are in no way intended to infer completeness or a preferred sequence. This list will require modification for other types of entities. Because this list is merely illustrative, some auditors may find it not extensive enough, while others may find it too detailed. Others may prefer a different organization or sequence for the inquiries. A firm that believes the questionnaire approach is appropriate for its practice should develop its own internal control structure questionnaires based on its own needs and preferences. In any event, users of checklists and questionnaires should recognize that important matters in a particular set of circumstances may not be covered in a standard checklist.

	Yes	No	N/A
.020			
I. Control Environment			
1. Does the owner reasonably understand the form and content of the financial statements and such required reports as tax returns?	____	____	____
2. Does the owner use operating budgets and cash projections? If so,	____	____	____
a. Do the budgets and projections lend themselves to effective comparison with actual results?	____	____	____
b. Are material variances reviewed and explained?	____	____	____
3. Are monthly comparative financial reports prepared which are sufficiently informative to highlight abnormalities?	____	____	____
4. Is there adequate control including a reporting schedule and assigned responsibility for preparation of required financial statements and government regulatory reports?	____	____	____
5. Are the personal funds of the owner including his personal income and expenses completely segregated from the business?	____	____	____
6. Is the bookkeeper required to take annual vacations and does someone else perform the bookkeeping duties during that time?	____	____	____
7. Are there adequate safekeeping facilities for custody of the accounting records such as fireproof storage areas and restricted access cabinets?	____	____	____
8. Is there adequate fidelity bond coverage of employees who handle cash, securities, other valuable assets and accounting records?	____	____	____
9. Is the adequacy of insurance coverage periodically reviewed?	____	____	____
10. Is there a suitable records retention plan?	____	____	____
11. Is the owner satisfied that all employees are competent and honest?	____	____	____
II. Accounting System and Control Procedures*			
.030 A. General			
1. Is a complete and current chart of accounts used?	____	____	____
2. Is a double entry bookkeeping system in use which includes a general ledger, source journals, and suitable subsidiary records?	____	____	____

* The accounting system and control procedure elements are combined because they are highly interrelated and often inseparable. Generally, the auditor has a greater responsibility to understand the accounting system than to understand specific control procedures.

Yes No N/A

3. Do the records provide for efficient accumulation of entries and avoidance of unnecessary duplicate work?
4. Are standard journal entries used to the extent practicable?
5. Are journal entries understood and authorized by the owner?
6. Are the source journals posted promptly and the general ledger and subsidiary ledgers kept current and balanced monthly?

.040 B. Identified Significant Classes of Transactions

1. Revenue Cycle (Revenue, Receivables, and Cash Receipts)?
2. Expenditures Cycle (Purchases, Payables, Payrolls, Cash Disbursements)?
3. Production or Conversion Cycle (Inventories, Cost of Sales, Property, Plant, and Equipment)?
4. Financing Cycle (Notes Receivable, Investments, Notes Payable, Debt, Other Long-Term Obligations, and Owner's Equity)?

III. Revenue Cycle (Revenue, Receivables & Cash Receipts)

.050 A. Understanding—Revenues and Accounts Receivable

1. How are sales transactions initiated?
2. What document or record is used to evidence initiation?
3. What are the responsibilities of personnel involved with initiating sales?
4. How are sales transactions recorded?
5. How often are sales journal entries prepared?
6. How are collections received?
7. What document or record is used to evidence collections?
8. What are the responsibilities of personnel involved with collections?
9. How often are bank deposits made?
10. How are credits to customers' accounts initiated?
11. What documents are used to evidence credits?
12. What are the responsibilities of personnel involved with initiating credits?

.060 B. Control Procedures—Revenues and Accounts Receivable

1. Is credit approved by the owner or a designated credit manager?
2. Are credit files maintained on a current basis for significant customers?
3. Are commission rates set or approved by the owner?
4. Are sales orders or work orders approved by the owner or a responsible employee for:
   a. Price?
   b. Terms of sale, including delivery dates?
   c. Credit?
   d. Account balance limits?
5. Are all sales orders (or work orders) recorded on pre-numbered forms and are all numbers accounted for?
6. Are shipping documents:
   a. Prepared for all shipments?
   b. Pre-numbered and all numbers accounted for?
   c. Based on approved sales orders and matched with sales invoices?
   d. Processed promptly?
7. Are all sales invoices:
   a. Pre-numbered and all numbers accounted for?
   b. Compared to shipping documents?
   c. Checked for price and terms?
   d. Checked for clerical accuracy?
   e. Recorded promptly?
8. Are all credit memos pre-numbered and all:

	Yes	No	N/A
a. Numbers accounted for?	____	____	____
b. Approved?	____	____	____
c. Recorded promptly?	____	____	____
9. Is there a proper cut-off of sales at month end?	____	____	____
10. Are monthly statements of account for all trade receivable balances:			
a. Reviewed by the owner before mailing?	____	____	____
b. Mailed by the owner or a responsible employee other than the bookkeeper?	____	____	____
11. Is the accounts receivable subsidiary ledger balanced monthly to the general ledger control account?	____	____	____
12. Is an aging schedule or schedule of past due customers' accounts prepared monthly?	____	____	____
13. Does the owner or credit manager review monthly listings of past due customer accounts and investigate delinquent accounts and unusual items?	____	____	____
14. Are write-offs and other adjustments to customers' accounts authorized by the owner?	____	____	____

.070 C. Control Procedures—Cash Receipts

	Yes	No	N/A
1. Does the owner or a responsible employee other than the bookkeeper or person who maintains accounts receivable detail:			
a. Open the mail and prelist all cash receipts before turning them over to the bookkeeper?	____	____	____
b. Stamp all checks with the restrictive endorsement "for deposit only" before turning them over to the bookkeeper?	____	____	____
c. Subsequently compare the daily prelisting of cash receipts with:			
(i) The cash receipts journal?	____	____	____
(ii) The duplicate deposit slip?	____	____	____
2. Are cash receipts deposited intact on a daily basis?	____	____	____
3. Are cash receipts posted promptly to the accounts receivable subsidiary records?	____	____	____
4. Are discounts taken checked for conformity with an authorized policy?	____	____	____
5. Are cash sales controlled by cash registers or pre-numbered cash receipt forms?	____	____	____
6. If cash registers are used, does a responsible employee other than the cash register operator (cashier)—			
a. Have custody at all times of the key to the cash register tape compartment?	____	____	____
b. Take periodic readings of the register and compare such with the cashier's record of cash receipts?	____	____	____

IV. Expenditures Cycle

.080 A. Understanding—Purchasing, Receiving, and Payables

1. How are purchase transactions initiated?
2. What document or record is used to evidence the initiation of purchases?
3. What are the responsibilities of personnel involved with initiating purchases?
4. How are purchase transactions recorded?
5. What document or record is used to evidence the receipt of purchased goods?

.090 B. Control Procedures—Purchasing

	Yes	No	N/A
1. Does the owner or a designated person other than the bookkeeper do the purchasing?	____	____	____
2. Are all purchases over a predetermined dollar amount approved by the owner?	____	____	____
3. Are purchases of services, property and equipment, investments and other non-routine items approved by the owner?	____	____	____
4. Are all purchases based on purchase orders which present descriptions, quantities, and prices which are approved before issuance?	____	____	____
5. Are all purchase order forms pre-numbered and is custody of unissued forms adequate to prevent their misuse?	____	____	____

	Yes	No	N/A
6. Are issued purchase orders listed in detail showing order numbers, vendors' names, quantities, and prices to control their issuance and disposition? (This may be in the form of a register, log, or file of copies of issued purchase order forms.)	___	___	___
7. Are open purchase orders periodically reviewed for delivery period so that past due orders may be brought to the owner's attention?	___	___	___

.100 C. Control Procedures—Receiving

	Yes	No	N/A
1. Are all materials inspected for condition and independently counted, measured or weighed when received?	___	___	___
2. Are receiving reports used and prepared promptly? (Note: copies of purchase orders with the quantities blanked out may serve this purpose.)	___	___	___
3. Are receiving reports subjected to the following:			
a. Pre-numbering and accounting for the sequence of all numbers? (This may be coordinated with accounting for all purchase orders—see items 5 and 6 in AAM section 4300.090.)	___	___	___
b. Promptly provided (by copies) to those who perform the purchasing and accounting (accounts payable) functions?	___	___	___
c. Controlled so that the liability may be determined for materials received but not yet invoiced?	___	___	___

.110 D. Control Procedures—Accounts Payable

	Yes	No	N/A
1. Are vendor's invoices:			
a. Matched with applicable purchase orders?	___	___	___
b. Matched with applicable receiving reports?	___	___	___
c. Reviewed for correctness of:			
(i) Quantities received?	___	___	___
(ii) Prices charged?	___	___	___
(iii) Clerical accuracy (extensions & footings)?	___	___	___
(iv) Account distribution?	___	___	___
2. Are all available discounts taken?	___	___	___
3. Is there written evidence that invoices have been properly processed (for example, a block stamp, attachment of a voucher form, annotations) before payment?	___	___	___
4. Are duplicate invoices conspicuously stamped or destroyed as a precaution against duplicate payment?	___	___	___
5. Are approved debit memos used to notify vendors of goods returned to them and other adjustments of their accounts?	___	___	___
6. Are there procedures which provide that direct shipments to customers, if any, are properly billed to them?	___	___	___
7. Does the owner verify that the trial balance of accounts payable agrees with the general ledger control account?	___	___	___
8. Does the owner verify that other key accounts agree with the subsidiary records?	___	___	___
9. Are vendors' statements reconciled with accounts payable detail?	___	___	___
10. Are vendors' statements checked by the owner periodically for overdue items?	___	___	___
11. Are expense accounts:			
a. Submitted promptly?	___	___	___
b. Adequately supported?	___	___	___
c. Approved before payment?	___	___	___

.120 E. Understanding—Payrolls

1. How is time worked by employees accounted for?
2. What document or record is used to evidence hours worked?

	Yes	No	N/A
3. What are the responsibilities of personnel involved in the computation of payroll?			
4. How are payroll transactions recorded?			

.130 F. Control Procedures—Payrolls

	Yes	No	N/A
1. Are all employees hired by the owner?			
2. Are individual personnel files maintained?			
3. Is access to the personnel files limited to the owner or a designee who is independent of the payroll or cash functions?			
4. Are wages, salaries, commission, and piece rates approved by the owner?			
5. Are proper authorizations obtained for all payroll deductions?			
6. Is gross pay determined using authorized rates and:			
a. Adequate time records for employees paid by the hour?			
b. Piece work records for employees whose wages are based on production?			
c. Are piece rate records reconciled with production records or are counts spot checked?			
d. Salesmen's commission records reconciled with sales records?			
7. If employees punch time clocks, are the clocks located so they may be watched by someone with authority?			
8. Are time records for hourly employees approved by a foreman or supervisor?			
9. Would the owner be aware of the absence of any employee?			
10. Is the clerical accuracy of the payroll checked?			
11. Are payroll registers reviewed by the owner?			
12. Is an imprest bank account used for payroll, and does the owner compare deposits to the account with the payroll register?			
13. Does the owner approve, sign, and distribute payroll checks?			
14. If employees are paid in cash, does the owner compare the cash requisition to the net payroll?			
15. Does the owner maintain control over unclaimed payroll checks?			

.140 G. Understanding—Cash Disbursements

1. How are cash disbursements initiated?
2. What document or record is used to evidence cash disbursements?
3. What are the responsibilities of personnel involved in disbursing cash?
4. How are cash disbursements recorded?

.150 H. Control Procedures—Cash Disbursements

	Yes	No	N/A
1. Are all disbursements except from petty cash made by check?			
2. Are checks pre-numbered and all numbers accounted for?			
3. Are all checks recorded when issued?			
4. Are all unused checks safeguarded (i. e., is access limited to the owner)?			
5. Is a mechanical check protector used to inscribe amounts as a precaution against alteration?			
6. Are all voided checks retained and mutilated?			
7. Are all checks signed by the owner?			
8. If a signature plate is used, is it under sole control of the owner?			
9. Are supporting documents (processed invoices, receiving reports, purchase orders, etc.) presented with the checks and reviewed by the owner before he signs the checks?			
10. Are supporting documents for checks properly cancelled to avoid duplicate payment?			
11. Are checks payable to cash prohibited?			
12. Are signed checks mailed by someone independent of the accounts payable function?			

	Yes	No	N/A
13. Are bank statements and paid checks:			
a. Received directly by the owner?	____	____	____
b. Reviewed by the owner before they are given to the bookkeeper?	____	____	____
14. Are bank reconciliations prepared:			
a. Monthly for all accounts?	____	____	____
b. By someone other than the cashier or persons authorized to sign checks or use a signature plate if they are other than the owner?	____	____	____
15. Are bank reconciliations reviewed and adjustments of the cash accounts approved by the owner?	____	____	____
16. Are all disbursements from petty cash funds supported by approved vouchers which are prepared in ink and cancelled to prevent reuse?	____	____	____
17. Is there a predetermined maximum dollar limit on the amounts of individual petty cash disbursements?	____	____	____
18. Are petty cash funds on an impress basis and:			
a. Kept in a safe place?	____	____	____
b. Reasonable in amount so that the fund ordinarily requires reimbursement at least monthly?	____	____	____
c. Controlled by one person?	____	____	____
d. Periodically counted by someone other than the custodian?	____	____	____

V. Production or Conversion Cycle

.160 A. Understanding—Inventories and Cost of Sales

	Yes	No	N/A
1. What types of documents or records are kept to control inventory items?	____	____	____
2. What are the responsibilities of personnel involved with inventory record keeping?	____	____	____

.170 B. Control Procedures—Physical Inventories

	Yes	No	N/A
1. Are physical counts made of all classes of inventory at least once a year?	____	____	____
2. Are physical inventory procedures supervised by the owner or a responsible employee?	____	____	____
3. Do written inventory procedures exist and, if so, are they determined or approved by the owner?	____	____	____
4. Do the inventory procedures adequately address the following matters:			
a. Location and orderly physical arrangement of inventories?	____	____	____
b. Identification and description of the inventories by persons familiar with it?	____	____	____
c. Segregation and proper identification of goods that are not property of the client, such as customers' goods and goods held on consignment?	____	____	____
d. Method of determining quantities such as weight, count or measure?	____	____	____
e. Identification of stock counted to determine all items are counted and to preclude duplicate counting?	____	____	____
f. Cutoff of receipts and deliveries?	____	____	____
g. Control of physical inventory records, such as pre-numbering of all count sheets, count tickets, and accounting for all numbered records issued and used?	____	____	____
h. Identification of slow moving, obsolete, and damaged items?	____	____	____
5. Are inventories under physical control of a designated storekeeper who is responsible for quantities and who is also not the bookkeeper?	____	____	____
6. Are there reasonable safeguards against theft or pilferage such as fences or locked areas?	____	____	____
7. Are the inventories adequately insured?	____	____	____

.180 C. Control Procedures—Perpetual Inventory Records

1. Are perpetual inventory records maintained and, if so,—

	Yes	No	N/A
a. Are the perpetual records controlled by general ledger accounts and adjusted to periodic physical inventories at least once a year?			
b. Are the perpetual records kept by someone other than the person(s) who has custody of the physical stock?			
c. Are differences between physical counts and perpetual records investigated?			
d. Are adjustments to the perpetual records approved by the owner?			

.190 D. Control Procedures—Costs

	Yes	No	N/A
1. Do the accounting records provide for properly classified accumulation of the costs of raw materials, direct labor, and overhead (including indirect labor)?			
2. Do the accounting records accumulate quantities or units of finished products sold and units of raw materials used in production in sufficient detail and with proper cut-off to provide for adequate determination of cost of goods sold and cost of inventories?			
3. Does the client's production process lend itself to accumulation of costs by job order or units processed, and if so, is an appropriate cost accounting system used?			
4. Is the cost accounting system tied in with or reconciled to the general ledger?			
5. Are production cost budgets and production reports prepared periodically?			
a. Do the budgets lend themselves to comparison with actual costs?			
b. Are differences between budget and actual costs investigated and explained?			
c. Are production cost budgets and comparisons with actual costs reviewed by the owner?			

.200 E. Control Procedures—Receipts, Usage, and Shipments

	Yes	No	N/A
1. Do receiving personnel verify the quantity and quality of materials purchased and prepare formal receiving reports?			
2. Are signed requisitions required for release of all materials from the storeroom and, if so, are the requisitions pre-numbered and all numbers accounted for?			
3. Are all shipments of finished goods based on approved shipping advices?			
4. Are shipping and receiving areas separate from inventory storage areas?			

.210 F. Understanding—Property, Plant, and Equipment

	Yes	No	N/A
1. Is there documentation of the records or documents which are maintained to control fixed assets?			
2. Are the responsibilities of company personnel as they relate to fixed assets record keeping documented?			

.220 G. Control Procedures—Property, Plant, and Equipment

	Yes	No	N/A
1. Are all additions authorized by the owner?			
2. Does the owner understand and approve the estimated lives and methods of depreciation for depreciable property?			
3. Does the owner authorize all retirements?			
4. Are there detailed records of property, plant, and equipment which— a. Identify specific assets including their costs and acquisition dates?			
b. Show related depreciation?			
c. Are balanced periodically (at least annually) with the general ledger control accounts?			
5. Are there adequate detailed records for leased property under capital leases?			
6. Are periodic physical inventories or inspections made of property, plant, and equipment?			
7. Are depreciable lives periodically reviewed for adequacy in relation to unanticipated use or obsolescence based on actual experience?			

	Yes	No	N/A

VI. Financing Cycle

.230 A. Understanding—Notes Receivable and Investments

1. Is there documentation of the records or documents which are maintained for notes receivable and investments? ____ ____ ____
2. Are the responsibilities of company personnel as they relate to notes receivable and investments record keeping documented? ____ ____ ____

.240 B. Control Procedures—Notes Receivable and Investments

1. Does the owner authorize all notes receivable? ____ ____ ____
2. Are all investment purchases and sales authorized by the owner? ____ ____ ____
3. Is a detailed record of notes and investments maintained including related income? ____ ____ ____
   a. Is the record kept current? ____ ____ ____
   b. Is the record reconciled to the general ledger control accounts? ____ ____ ____
4. Are investments registered in the name of the company? ____ ____ ____
5. Does owner have sole access to notes and investment certificates? ____ ____ ____
6. Are investments kept in a safe place? ____ ____ ____
7. Are investments counted or confirmed periodically? ____ ____ ____

.250 C. Understanding—Notes Payable, Debt, and Other Term Obligations

1. Is there documentation of the records or documents which are maintained for notes payable, debt, and other long-term obligations? ____ ____ ____
2. Are the responsibilities of company personnel as they relate to notes payable, debt, and other long-term obligations documented? ____ ____ ____

.260 D. Control Procedures—Notes Payable, Debt, and Other Term Obligations

1. Does the owner negotiate all borrowings? ____ ____ ____
2. Does the owner understand the terms, conditions and finance cost (interest) of all debt and lease obligations of a financing nature? ____ ____ ____
3. Are detailed, up-to-date records maintained of notes payable, long-term debt, and other term obligations such as leases? ____ ____ ____
4. Are the company files adequate regarding copies of outstanding notes, bonds, mortgages, and leases? ____ ____ ____
5. Are paid bonds and notes effectively cancelled and retained in the company? ____ ____ ____

.270 E. Control Procedures—Owner's Equity

1. If doing business as a corporation:
   a. Are the owner's records safeguarded and in order regarding the certificate or articles of incorporation, bylaws, unissued stock certificates (if any), and relevant correspondence with legal counsel? ____ ____ ____
   b. Does the general ledger include appropriate capital accounts? ____ ____ ____
   c. Are minute books maintained and properly safeguarded? ____ ____ ____
2. If doing business as a sole proprietorship, does the general ledger include appropriate capital accounts? ____ ____ ____

[The next page is 4401.]

AAM Section 4400

Illustrative Specific Internal Control Structure Objectives and Related Questions—Medium to Large Business

.010 This section lists specific internal control structure objectives and related questions that an auditor might raise concerning a medium to large business with enough employees to be able to achieve a reasonable segregation of duties. These illustrative objectives and related questions are organized into control environment, accounting system, and four broad transaction classes which are further divided into various subheadings. This is to provide some additional illustration of the concepts discussed in AAM section 4200.18 on organization of checklist questionnaires and other generalized aids.

.020 As discussed in AAM section 4200.15—.17, auditors develop various generalized materials as aids for documenting the internal control structure and assessing control risk. Many of these aids consist of questions or statements about particular policies or procedures but do not include specific internal control structure objectives. Some materials, however, include statements of specific internal control structure objectives in addition to the traditional questions or statements on policies and procedures. The number and degree of detail of the sets of objectives included in these materials vary. For example, they range in number from about 40 to over 100. These variations depend on the needs and preferences of the auditors who developed the materials.

.030 The illustrative material in this section includes 62 specific internal control structure objectives accompanied by related questions concerned with how the objectives may be accomplished. In a number of instances the questions require a comment rather than a simple yes or no answer; these instances should be self-evident. Because some policies and procedures may accomplish more than one objective, there are instances when a group of questions is associated with two or more objectives. Likewise, there is some repetition among the various groups of questions associated with different specific objectives. Some of the questions are of a general nature and are accompanied by examples of more specific policies and procedures.

.040 A firm should develop or adopt guidance material which is appropriate for its own needs and preferences. In any event, users of this illustrative material or other such material must use professional judgment and be alert for important matters in a particular set of circumstances which may not be covered in the illustrative material. For example, some companies may have developed additional specific internal control structure objectives to meet special circumstances. Also, some of the specific internal control structure objectives included in generalized material may not be applicable to some companies because of the absence of certain types of transactions.

	Yes	No	N/A
I. Control Environment			
.050 A. Management Philosophy and Operating Style			
Questions—Policies and Procedures			
1. Does management have clear objectives in terms of budget, profit, and other financial and operating goals?	____	____	____
2. Are such policies:			
a. Clearly written?	____	____	____
b. Actively communicated throughout the entity?	____	____	____
c. Actively monitored?	____	____	____

	Yes	No	N/A
3. Does management adequately consider the potential effects of taking large or unusual business risks prior to doing so?	____	____	____
4. Are business risks adequately monitored?	____	____	____

.060 B. Organizational Structure

Objective

- Definitions of responsibilities and authority assigned to specific individuals permit identification of whether persons are acting within the scope of their authority.

Questions—Policies and Procedures

	Yes	No	N/A
1. Is the organization of the entity clearly defined in terms of lines of authority and responsibility?	____	____	____
2. Does the entity have a current organization chart and related materials such as job descriptions and lists of particular individuals which clearly identify:			
a. The responsibilities and authority assigned to senior management personnel?	____	____	____
b. Individuals specifically authorized to initiate and execute transactions?	____	____	____
c. Individuals with specific responsibility for custody of various classifications of assets?	____	____	____
d. Individuals with specific responsibility for financial control functions?	____	____	____
3. Are policies and procedures for authorization of transactions established at an adequately high level?	____	____	____
4. Are such policies and procedures adequately adhered to?	____	____	____

.070 C. Audit Committee

Questions—Policies and Procedures

	Yes	No	N/A
1. Does the board of directors have an audit committee?	____	____	____
2. Does the audit committee take an active role in overseeing the entity's accounting and financial reporting policies and practices?	____	____	____
3. Is this evidenced by:			
a. Regularly held meetings?	____	____	____
b. The appointment of members with adequate qualifications?	____	____	____
4. Does the audit committee:			
a. Adequately assist the board of directors in meeting its fiduciary responsibilities?	____	____	____
b. Adequately assist the board in maintaining a direct line of communication with the entity's internal and external auditors?	____	____	____

.080 D. Methods of Assigning Authority and Responsibility

Questions—Policies and Procedures

	Yes	No	N/A
1. Does the entity have a written code of conduct and conflict of interest requirements?	____	____	____
2. Are the code and requirements actively enforced?	____	____	____
3. Are authority and responsibility to deal with organizational goals and objectives, operating functions, and regulatory requirements adequately delegated?	____	____	____
4. Are employees given job descriptions which delineate specific duties, reporting relationships, and constraints?	____	____	____
5. Has the entity developed computer systems documentation which indicates the procedures for authorizing transactions and approving systems changes?	____	____	____

	Yes	No	N/A
.090 E. Management Control Methods			
Questions—Policies and Procedures			
1. Are there regular meetings of the board of directors (or comparable bodies) to set policies and objectives, review the entity's performance and take appropriate action, and are minutes of such meetings prepared and signed on a timely basis?	____	____	____
2. Has the entity established planning and reporting systems that set forth management's plans and the results of actual performance?	____	____	____
3. Do the planning and reporting systems in place:			
a. Adequately identify variances from planned performance?	____	____	____
b. Adequately communicate variances to the appropriate management level?	____	____	____
4. Does the appropriate level of management:			
a. Adequately investigate variances?	____	____	____
b. Take appropriate and timely corrective action?	____	____	____
5. Does the entity have established policies for developing and modifying accounting systems and control procedures?	____	____	____
.100 F. Internal Audit Function			
Questions—Policies and Procedures			
1. Does the entity have an internal audit function?	____	____	____
2. If an internal audit function is present:			
a. Are the internal auditors independent of the activities they audit?	____	____	____
b. Is the internal audit function adequately staffed in terms of the number of employees, and their training and experience?	____	____	____
c. Do the internal auditors document the internal control structure and perform tests of controls?	____	____	____
d. Do they perform substantive tests of the details of transactions and account balances?	____	____	____
e. Do they document the planning and execution of their work by such means as audit programs and working papers?	____	____	____
f. Do they render written reports on their findings and conclusions?	____	____	____
g. Are their reports submitted to the board of directors or to a committee thereof?	____	____	____
3. Does management take adequate and timely actions to correct conditions reported by the internal audit function?	____	____	____
4. Does the internal audit function follow up on corrective actions taken by management?	____	____	____
.110 G. Personnel Policies and Procedures			
Questions—Policies and Procedures			
1. Does the entity:			
a. Adequately plan for staff needs?	____	____	____
b. Employ sound hiring practices, including background investigations, where appropriate?	____	____	____
2. Are employees adequately trained to meet their job responsibilities?	____	____	____
3. Does the entity systematically evaluate the performance of employees?	____	____	____
4. Is good performance appropriately rewarded?	____	____	____
5. Does the entity timely dismiss employees for critical violations of control policies?	____	____	____
6. Are employees in positions of trust:			
a. Bonded?	____	____	____
b. Required to take mandatory vacations?	____	____	____

	Yes	No	N/A

II. Accounting System

.120 A. General Accounting

Objectives

- Accounting policies and procedures, including selection among alternative accounting principles, are determined in accordance with management's authorization.
- Access to the accounting and financial records is limited to minimize opportunities for errors and irregularities and to provide reasonable protection from physical hazards.
- Accounting entries are initiated and approved in accordance with management's authorization.
- All accounting entries are appropriately accumulated, classified, and summarized in the accounts.

Questions—Policies and Procedures

1. Does the entity have adequate written statements and explanations of its accounting policies and procedures? ____ ____ ____

   (Written accounting policies and procedures may include such matters as:
   (i) Chart of accounts accompanied by explanations of the items to be included in the various accounts.
   (ii) Identification and description of the principal accounting records, recurring standard entries, and requirements for supporting documentation. For example, this may include information about the general ledger and journal, and the subsidiary transaction registers, accounts, and detail records for each of the various significant classes of transactions.
   (iii) Expression of the assignment of responsibilities and delegation of authority including identification of the individuals or positions that have authority to approve various types of recurring and non-recurring entries.
   (iv) Explanations of documentation and approval requirements for various types of recurring and non-recurring transactions and journal entries. Documentation requirements, for example, would include the basis and supporting computations required for adjustments and write-offs.
   (v) Instructions for determining an adequate cutoff and closing of accounts for each reporting period.)
2. Is responsibility assigned for initiation and approval of revisions in the accounting policies and procedures? ____ ____ ____
3. Are the entity's accounting policies and procedures adequately communicated to appropriate personnel (for example, by distribution of written instructions and manuals to persons who need them)? ____ ____ ____
4. Does the principal accounting officer of the entity have adequate authority over accounting employees and principal accounting records at all locations? ____ ____ ____

   (Accounting employees of an operating division or subsidiary may report to the operating manager in charge of the division or subsidiary. In these situations it is especially important that those responsible for accounting and reporting at the divisional or subsidiary level be fully advised of the accounting and reporting policies they are expected to follow.)
5. Is maintenance of the general ledger performed by persons whose duties do not include:
   a. Direct access to assets such as handling cash receipts, custody of marketable securities, receiving of purchased goods, and shipping of finished product? ____ ____ ____
   b. Performance of functions which provide indirect access to assets such as signing checks, approving invoices, approving purchase orders, authorizing production, extending credit, and approving sales orders? ____ ____ ____
   c. Maintenance of subsidiary ledgers and records? ____ ____ ____
6. Is access to the general ledger and related records restricted to those who are assigned general ledger responsibilities? ____ ____ ____
7. Are there adequate facilities for custody of the general ledger and related records? ____ ____ ____

	Yes	No	N/A
(Examples of such facilities include fire-resistant locked cabinets, vaults, physical barriers, separate rooms, limited access to work areas, alarms, and other detection devices.)			
8. Is appropriate insurance coverage maintained in accordance with management's authorization?	___	___	___
(Such insurance may include loss of records coverage and fidelity bonding of employees in positions of trust.)			
9. Are all journal entries reviewed and approved by designated individuals at appropriate levels in the organization?	___	___	___
(The levels at which journal entries are reviewed and approved will usually vary depending on whether the entries are recurring or non-recurring, routine or unusual, accumulations of routine expected transactions or adjustments of balances requiring estimates and judgments.)			
10. Are all journal entries adequately explained and supported?	___	___	___
(Explanation and support for an entry should be sufficient to enable the person responsible for its review and approval to reasonably perform this function.)			
11. Are the individuals designated to review and approve journal entries independent of initiation of the entries they are authorized to approve?	___	___	___
12. Do all journal entries include indication of approval in accordance with management's general or specific authorization?	___	___	___
13. Are all accounting entries subject to the controls over completeness of processing?	___	___	___
(Examples of controls over completeness of processing include pre-numbering of journal vouchers and accounting for all numbers used, accumulation of control totals of dollar amounts debited and credited, and standard identification numbers for recurring standard accounting entries.)			
14. Do all journal entries include adequate identification of the accounts in which they are to be recorded?	___	___	___
15. Are there adequate detailed records to support entries regarding:			
a. Amortization of prepaid expenses, deferred charges, and intangible assets?	___	___	___
b. Revenue recognition of deferred income?	___	___	___
c. Liability accruals and provisions relating to such matters as product warranties?	___	___	___
d. Provisions and liabilities for income taxes and other taxes?	___	___	___
e. Liability accruals and provisions for such long-term agreements as pension plans and deferred compensation arrangements?	___	___	___
16. Are adequate accounts and records maintained so that adjustments and write-offs made to account balances do not impair accountability for actual amounts?	___	___	___
(Examples are use of contra (allowance) accounts to accumulate valuation adjustments of asset balances, and use of memorandum accounts to control bad debts which have been written off.)			

.130 B. Preparation of Financial Statements

Objectives

- The general ledger and related records permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements and reports.
- Individuals at appropriate levels in the organization consider sufficient, reliable information in making the estimates and judgments required for preparation of financial statements including related disclosures and other externally reported financial information.
- Financial statements including related disclosures are prepared and released in accordance with management's authorization.

	Yes	No	N/A

Questions—Policies and Procedures

1. Are the general ledger accounts arranged in orderly groupings which are conducive to efficient statement preparation? ___ ___ ___
2. Are financial reports of consolidated divisions, subsidiaries and affiliates prepared in prescribed formats which are conducive to efficient combination and consolidation? ___ ___ ___
3. Are there adequate instructions and procedures for statement preparation? ___ ___ ___

   (Instructions and procedures, for example, may include the following:

   (i) Written financial statement closing schedule with assignment of specific preparation and review responsibilities.

   (ii) Standard forms and accompanying instructions that identify for such entities as branches, divisions, and subsidiaries the data they are to report (for example, consistent groupings and identification of intercompany amounts).

   (iii) Accumulation of information on intercompany transactions.

   (iv) Accumulation of information for disclosure in notes to financial statements.)
4. Are there adequate detailed records and procedures (for preparation and review) for—

   a. Entries to develop consolidated financial statements such as eliminations and recording of goodwill and/or minority interest? ___ ___ ___

   b. Reclassification entries? ___ ___ ___
5. Are policies and procedures adequate for informing appropriate levels of management on a timely basis of—

   a. Significant, unusual, or nonrecurring transactions or events and considerations concerning their accounting recognition? ___ ___ ___

   b. Requirements of existing and new accounting rules, and of the rules and regulations of appropriate regulatory bodies? ___ ___ ___
6. Are estimates of net realizable value of assets and related adjustments to provide valuation allowances, and/or to write down asset balances, reviewed and approved by designated individuals at appropriate levels in the organization who are independent of the persons originating such estimates and adjustments? ___ ___ ___
7. Are procedures adequate for the review and comparison of financial statement working papers to source data and a comparison of elimination, and reclassification entries to those made in prior periods? ___ ___ ___
8. Are financial statements subjected to overall review, including comparisons with the prior period and budgeted amounts, by appropriate levels of management before the statements are approved for issuance? ___ ___ ___

.140 C. Identified Significant Classes of Transactions

1. Revenue Cycle (Revenue, Receivables, and Cash Receipts)? ___ ___ ___
2. Expenditures Cycle (Purchases, Accounts Payable, Payroll, and Cash Disbursements)? ___ ___ ___
3. Production (Conversion) Cycle (Production Costs, Inventories, Property, and Equipment)? ___ ___ ___
4. Financing Cycle (Investments, Borrowings, Equity, Cash Collections, and Disbursements)? ___ ___ ___

III. Revenue Cycle

A. Revenue and Receivables

.150 Sales Orders

	Yes	No	N/A

Objectives

- The types of goods and services to be provided, the manner in which they will be provided, and the customers to which they will be provided are in accordance with management's authorization.
- The prices and other terms of sale of goods and services are established in accordance with management's authorization.

Questions—Control Policies and Procedures

1. Do policies and procedures for acceptance and approval of sales orders appear clearly defined and adequately communicated for:
   a. Standard goods and services? ____ ____ ____
   b. Nonstandard goods and services? ____ ____ ____
   c. Unusual delivery arrangements? ____ ____ ____
   d. Export sales? ____ ____ ____
   e. Sales to related parties? ____ ____ ____
2. Is responsibility clearly assigned for approval of sales orders (customer acceptance, credit clearance, and other terms of sale) before shipment or performance? ____ ____ ____
3. Are sales orders approved in accordance with management's general or specific authorization before shipment or other performance concerning:
   a. Customer? ____ ____ ____
   b. Description and quantities? ____ ____ ____
   c. Price? ____ ____ ____
   d. Other terms of sale (for example, discounts, warranties, time commitments)? ____ ____ ____
   e. Credit (account balance limits)? ____ ____ ____

   (In some instances, these matters may be recorded in computer stored master files. In these instances, consideration should be given to controls over the integrity and timely updating of the files.)
4. Are all approved sales orders recorded on appropriate forms (shipping orders, work orders, etc.) which include indication of proper approval and are subject to:
   a. Pre-numbering? ____ ____ ____
   b. Accounting for all forms used? ____ ____ ____
   c. Recording in detail? ____ ____ ____

   (For example, listing in a register or log, or retention of copies of all sales orders issued in a file.)

   d. Timely communication to persons who perform the shipping or service function? ____ ____ ____
5. Are there appropriate procedures for approval of "No charge" services and services performed under a warranty? ____ ____ ____
6. Are unfilled sales commitments periodically reviewed? ____ ____ ____
7. Is current information on prices, and policies on such matters as discounts, sales taxes, freight, service, warranties and returned goods clearly communicated to sales and billing personnel? ____ ____ ____

   (For example, such information may be communicated through approved sales catalogs, sales manuals or authorized price lists.)

	Yes	No	N/A
8. Is there timely communication of salesmen's commission rates to persons performing the sales and accounting functions?			
(For example, approved commission schedules.)			

.160 Credit

Objective

- Credit terms and limits are established in accordance with management's authorization.

Questions—Control Policies and Procedures

	Yes	No	N/A
1. Do policies on acceptance of credit risk appear clearly defined and adequately communicated?			
2. Is the credit of prospective customers investigated before it is extended to them?			
3. Is there periodic review of credit limits?			
4. Are persons who perform the credit function independent of sales, billing, collection, and accounting functions?			
5. Do persons who perform the credit function receive timely information about past due accounts?			
6. Is there timely communication of credit limits and changes of credit limits to persons responsible for approving sales orders?			

.170 Shipments

Objectives

- Goods delivered and services provided are based on orders which have been approved in accordance with management's authorization.
- Deliveries of goods and rendering of services result in preparation of accurate and timely billings.

Questions—Control Policies and Procedures

	Yes	No	N/A
1. Are goods shipped or services rendered based on documented sales or work orders which include indication of approval in accordance with management's authorization?			
2. Are shipping documents prepared for all shipments?			
3. Are shipping documents subjected to:			
a. Pre-numbering?			
b. Accounting for all shipping documents issued?			
c. Recording in detail?			
(For example, listing in a register or log, or retention of copies of all shipping documents issued in a file.)			
d. Timely communication to persons who physically perform the shipping function?			
e. Timely communication to persons who perform the billing function?			
f. Timely communication to persons who perform the inventory control function?			
(In some systems, copies of the sales order may serve as shipping documents.)			
4. Do shipping documents provide indication of:			
a. Adequate cross-reference to the applicable properly approved sales order?			
b. Customer identity?			
c. Location to which shipment is made?			
d. Description and quantities of goods shipped?			
e. Date of shipment?			
f. Means of shipment (carrier, etc.)?			

	Yes	No	N/A
g. Indication of receipt?			
5. Are persons who perform the shipping function independent of the sales, billing, cash and accounting functions?			
6. Is access to finished goods and merchandise restricted so that withdrawals of inventory are based only on properly approved sales orders?			
7. Are quantities of goods shipped verified, for example, by double counting or comparison with independent counts by common carriers?			
8. Are shipping and performance documents reviewed and compared with billings on a timely basis to determine that all goods shipped or services rendered are billed and accounted for?			

.180 Billings and Records

Objectives

- Sales and such related transactions as commissions and sales taxes are based on deliveries of goods or rendering of services and recorded at the correct amounts and in the appropriate period and are properly classified in the accounts.
- Sales related deductions and adjustments are made in accordance with management's authorization.

Questions—Control Policies and Procedures

	Yes	No	N/A
1. Are sales invoices prepared for all shipments of goods or services rendered (including purchases which are shipped directly to customers)?			
(In some situations, it is practical to have posting of sales orders include simultaneous preparation of such related forms as shipping orders, billings, and if applicable, salesmen's commission advices.)			
2. Are billing and invoice preparation functions performed by persons who are independent of the selling (soliciting and receiving orders from customers), credit, and cash functions?			
3. Are all sales invoices:			
a. Pre-numbered?			
b. Accounted for to determine all invoices are recorded?			
c. Matched with properly approved sales orders?			
d. Matched with shipping documents?			
e. Traced to authorized current source information on prices and terms (for example, price lists, schedules, catalogues, or computer stored master files)?			
f. Checked for clerical accuracy by recomputation of extensions and footings?			
g. Recorded promptly?			
4. Are sales invoices listed in detail?			
(For example, the listing may be a sales journal, file of invoice copies, or computer prepared transaction file.)			
5. Are there suitable chart of accounts, standard journal entries, control accounts and subsidiary records for recording, classifying and summarizing revenues, receivables, collections and such related items as commissions, and provision of allowances for doubtful accounts and product warranties?			
6. Is there a proper cutoff of sales and sales adjustments at month end?			
(For example, adjustments for shipments not invoiced to customers, sales invoices not recorded, and sales returns or credit adjustments not recorded.)			
7. Are all credit memos (for example, adjustments, allowances and returns):			
a. Pre-numbered and all numbers accounted for?			
b. Matched when applicable with receiving reports for returns?			
c. Approved by a responsible employee other than the person initiating preparation of the credit memo?			

	Yes	No	N/A
d. Recorded promptly?	___	___	___
8. Are commissions based on rates which are in accordance with management's general or specific authorization?	___	___	___
9. Is the accounts receivable subsidiary ledger reconciled monthly to the general ledger control account?	___	___	___
10. Are monthly statements and specific billings sent for trade receivables:			
a. Reviewed by a responsible employee who is independent of the accounts receivable and cash functions?	___	___	___
b. Mailed by a responsible employee who is independent of the accounts receivable and cash functions?	___	___	___
11. Is an aging schedule or schedule of past due accounts prepared monthly by someone independent of the billing and cash receipts functions?	___	___	___
12. Does the credit manager review monthly aging schedules or listings of past due customer accounts and investigate delinquent accounts and unusual items on a timely basis?	___	___	___
13. Is there documentation of review and analysis of accounts receivable balances to determine valuation allowances (for doubtful accounts) and any specific balances to be written-off?	___	___	___
14. Are valuation allowances and write-offs approved by a responsible employee?	___	___	___
15. Are written-off accounts receivable subject to memorandum control and follow-up by an employee independent of the cash receipts function?	___	___	___
16. Are written-off accounts receivable turned over to lawyers or collection agencies?	___	___	___

B. Cash Receipts [1]

.190 Processing Collections

Objectives

- Access to cash receipts and cash receipts records, accounts receivable records, and billing and shipping records is controlled to prevent or detect, on a timely basis, the taking of unrecorded cash receipts or the abstraction of recorded cash receipts.
- Detail transaction and account balance records are reconciled, at reasonable intervals, with applicable control accounts and bank statements for timely detection and correction of errors.

Questions—Control Policies and Procedures

	Yes	No	N/A
1. Is the mail opened by a person(s) whose duties do not involve any shipping, billing, accounts receivable detail, general ledger, invoice processing, payroll and cash disbursement functions?	___	___	___
2. Does the person(s) who opens the mail:			
a. Place restrictive endorsements on all checks as received so they are for deposit only to the bank accounts of the company?	___	___	___
b. List or otherwise obtain control (for example, by photocopying) over all remittances and prepare totals at least daily?	___	___	___
c. Forward all remittances to the person who prepares and makes the daily bank deposit?	___	___	___

[1] The illustrative internal control structure objectives and related questions for the cash receipts sections of the revenue cycle (AAM section 4400.190—.200) are duplicated in AAM section 4400.500—.510 because some accountants may prefer to consider them as part of a financing (treasury) cycle.

	Yes	No	N/A
d. Forward the total of remittances to persons independent of physical handling of remittances and accounts receivable detail functions for subsequent comparison with the authenticated duplicate deposit slip and control over postings to subsidiary records?	___	___	___
(In lock box arrangements, customers would mail their remittances to a post office box controlled by the company's bank which would have responsibility for functions 2a-2d.)			
3. Are receipts of currency controlled by cash registers and/or pre-numbered cash receipt forms?			
a. If cash registers are used, is a copy of the tape given to the customer as a receipt, and:			
(1) Is the key to the cash register tape compartment in the custody at all times of a responsible employee other than the cash register operator(s)?	___	___	___
(2) Are readings of the register periodically taken and compared with the cashier's records of receipts by a responsible employee other than the cash register operators?	___	___	___
b. If pre-numbered receipts are used for currency collections:			
(1) Is a copy given to the payor as a receipt?	___	___	___
(2) Are all pre-numbered receipts accounted for by a person(s) other than the person(s) handling cash received and balanced with the daily cash received?	___	___	___
c. If cash collections are for payments on account, is adequate information given for accurate posting to accounts receivable detail?			
d. If significant cash sales are made (as in a retail store) are spot checks made to determine that cashiers are following prescribed procedures?	___	___	___
4. Are currency receipts forwarded daily to the person who prepares the daily bank deposit?	___	___	___
5. Is a summary listing of daily currency receipts forwarded to a person(s) independent of physical handling of remittances and accounts receivable detail functions?	___	___	___
6. Do areas involving physical handling of cash appear reasonably safeguarded?	___	___	___
(For example, protective windows, vaults, cashier cages, etc.)			
7. Are each day's receipts (by mail and over the counter) except for post-dated items deposited intact daily?	___	___	___
8. Are post-dated items segregated on daily detail listings of remittances to aid in control of total items received?	___	___	___
9. Are all employees who handle receipts adequately bonded?	___	___	___
10. Are banks instructed not to cash checks and other instruments (for example, drafts, money orders, etc.) drawn to the order of the company?	___	___	___
11. Does company policy prohibit the cashing of any accommodation checks (for example, personal and payroll checks) out of collections?	___	___	___
12. Are local bank accounts used for branch office collections subject to withdrawal only by the home office?	___	___	___
13. Are banks instructed to deliver charged back deposit items (such as checks returned because of insufficient funds) directly to an employee independent of physical handling of cash receipts and posting of accounts receivable detail?	___	___	___
14. Are bank chargebacks received directly from the bank and investigated by a person independent of:			

	Yes	No	N/A
a. Physical handling of collections?			
b. Posting accounts receivable subsidiary detail?			
15. Are entries to the cash receipts journal compared with:			
a. Duplicate deposit slips authenticated by the bank?			
b. Deposits per the bank statements?			
c. Listings prepared (initial control) when mail is opened?			
16. Are the comparisons described in item 15 above made by a person(s) whose duties do not include cash receipts and accounts receivable functions?			

.200 Recording Collections

Objective

- All cash receipts are recorded at the correct amounts in the period in which received, and are properly classified and summarized.

Questions—Control Policies and Procedures

	Yes	No	N/A
1. Is information captured from remittances (by mail and over the counter) adequate for accurate posting of credits to individual accounts receivable subsidiary records or to classifications concerning such other sources as investment income, rents, sales of property or scrap, and proceeds of financing?			
(This information, for example, may be included on the listing prepared when the mail is opened, remittance advices which accompany customers' checks, detachable stubs from billings, photocopies of checks, copies of pre-numbered receipts issued for currency collections, etc.)			
2. Are details of daily collections balanced with the total credits to be distributed to appropriate general ledger accounts and to the total collections for the day before posting to the subsidiary records?			
3. Do postings of the general ledger control accounts and subsidiary records include the date on which the remittance was received?			
4. Are postings to the general ledger control accounts made by a person(s) independent of:			
a. Physical handling of collections?			
b. Posting accounts receivable subsidiary detail?			
5. Are details of collections posted to subsidiary accounts receivable records by a person(s) independent of:			
a. General ledger functions?			
b. Physical handling of collections?			
c. Receipt and investigation of bank chargebacks?			

IV. Expenditures Cycle

A. Purchases and Accounts Payable

.210 Purchases

Objectives

- The types of goods, other assets, and services to be obtained, the manner in which they are obtained, the vendors from which they are obtained, the quantities to be obtained and the prices and other terms are initiated and executed in accordance with management's general or specific authorization.
- Adjustments to vendor accounts and account distributions are made in accordance with management's general or specific authorization.

Questions—Control Policies and Procedures

	Yes	No	N/A
1. Are all purchases based on requisitions which have been approved in accordance with management's authorization?	____	____	____
(For example, management's authorization may be general in that requisitions for certain types of purchases may be based on automatic reorder points which were previously approved. Management's authorization may be specific in that only specific employees may be authorized to approve requisitions for certain types of purchases.)			
2. Are purchases made in accordance with management's prescribed guidelines for vendor acceptability?	____	____	____
(For example, guidelines for vendor acceptability may be based on such considerations as past performance, reputation, and credit standing; ability to meet delivery, quality, and service specifications; price competitiveness; legal restrictions; and policies on related party transactions. Lists of approved vendors may be developed based on such acceptability guidelines. Competitive bids may be required for items over predetermined dollar amounts from a list of several designated major vendors.)			
3. Are written purchase orders used for all commitments and do those orders include the vendor description, quantity, quality, price, terms, and delivery requirements for the goods or services ordered?	____	____	____
4. Are all purchase orders, before issuance, approved by specific individuals or classes of individuals designated by management?	____	____	____
5. Are all purchase orders pre-numbered?	____	____	____
6. Are all purchase orders routinely accounted for?	____	____	____
7. Are all purchase orders listed in detail?	____	____	____
(Examples include a register, log, computer tabulation, or file of copies of issued order forms.)			
8. Is there a record of open purchase commitments?	____	____	____
(Examples include periodic routine listings of open items prepared from a register, a file of open order copies, a computer master file of open orders.)			
9. Is the purchasing function independent of receiving, shipping, invoice processing, and cash functions?	____	____	____
10. Is custody of unissued purchase order forms adequate to prevent their misuse?	____	____	____
11. Are open purchase orders periodically reviewed and investigated?	____	____	____

.220 Receiving

Objectives

- All goods, other assets and services received are accurately accounted for on a timely basis.
- Only authorized goods, other assets, and services are accepted and/or paid for.

Questions—Control Policies and Procedures

	Yes	No	N/A
1. Are all goods received inspected for condition and independently counted, weighed or measured to provide for comparison with the applicable purchase order?	____	____	____
2. Is there evidence that all services received are evaluated for quality and completeness?	____	____	____
3. Are procedures adequate for timely communication concerning shortages or damaged goods?	____	____	____

	Yes	No	N/A
4. Are receiving reports prepared promptly for all goods received?	____	____	____

(For example, copies of purchase orders with the quantities blanked out may serve this purpose. Receiving reports may also be used to record such matters as receipt of pieces of leased equipment.)

	Yes	No	N/A
5. Do receiving reports provide for recording of:			
a. Description, quantity, and acceptability of goods or services received?	____	____	____
b. Date on which the goods or services are received?	____	____	____
c. Signature of the individual approving the receipt?	____	____	____
6. Are receiving reports subjected to the following:			
a. Pre-numbering?	____	____	____
b. Listing in detail?	____	____	____

(For example, a complete set of file copies in numerical or chronological sequence, a receiving log, etc.)

	Yes	No	N/A
c. Accounting for all receiving reports used?			
d. Distribution of copies for timely matching with purchase orders and vendor's invoices and, if applicable, timely maintenance of perpetual inventory records?	____	____	____
7. Are receiving functions performed by designated employees who are independent of the purchasing, shipping, invoice processing, and cash functions?	____	____	____
8. Is there a separate inspection function?	____	____	____

.230 Invoice Processing

Objectives

- Only authorized goods, other assets and services received are paid for.
- Amounts payable for goods and services received are accurately recorded at the correct amounts in the appropriate period and are classified in the accounts to:
  (1) Permit preparation of reports and statements in conformity with generally accepted accounting principles or other criteria.
  (2) Maintain accountability for costs incurred.
- Access to purchasing, receiving, and accounts payable records is suitably controlled to prevent or detect within a timely period duplicate or improper payments.

Questions—Control Policies and Procedures

	Yes	No	N/A
1. Are vendors' invoices processed by designated employees who are independent of the purchasing, receiving, shipping, and cash functions?	____	____	____
2. Are all vendors' invoices received directly by the designated employees (accounts payable department) who perform the invoice processing function?	____	____	____
3. Is control established over all invoices received?	____	____	____

(For example, control may be established over invoices received by prompt matching with a pre-numbered internally prepared document such as a purchase order and assignment of that number to the invoice. Another approach may consist of assignment of a voucher number and entry into a register.)

	Yes	No	N/A
4. Are duplicate invoices conspicuously stamped or destroyed as a precaution against duplicate payment?	____	____	____
5. Are there a suitable chart of accounts and established guidelines for assigning account distributions to processed invoices?			
6. Are vendors' invoices, prior to payment, compared in detail to:			
a. Purchase orders?	____	____	____
b. Receiving reports?	____	____	____
c. Evidence of direct shipment to customers?	____	____	____

(For example, copy of vendor's shipping document or acknowledgment of receipt by the customer)

	Yes	No	N/A
d. Debit memoranda?	____	____	____

	Yes	No	N/A
e. Evaluation reports on services rendered?			
7. Are vendors' invoices, prior to payment, reviewed for correctness of:			
a. Clerical accuracy (extensions and footings)?	____	____	____
b. Freight charges?	____	____	____
c. Account distribution?	____	____	____
8. Is there documented evidence that invoices have been subjected to prescribed processing routines, assigned specific account distributions and approved before payment?	____	____	____
(Examples include use of a block stamp which has been initialled or signed, attachment of a completed voucher form, attachment of copies of the purchase order and receiving report, and routine annotations on the invoice.)			
9. Are all available discounts taken?	____	____	____
10. Are processed invoices and supporting documents approved by designated employees before payment?	____	____	____
11. Are there procedures for periodic review and investigation of unprocessed invoices, unmatched purchase orders, and unmatched receiving reports which provide for appropriate follow-up and appropriate financial statement accruals?	____	____	____
12. Are approved debit memos used to notify vendors of goods returned and other adjustments of their accounts?	____	____	____
13. Are processed invoices listed in detail to facilitate timely determination of accounts payable and related account distribution of filled purchase commitments?	____	____	____
(For example, entries in a voucher register and periodic preparation of unpaid voucher listings, computer prepared listings of transaction detail and master files for vendor accounts, files of unpaid processed invoices, etc.)			
14. Are accumulation of processed invoices and follow-up of unmatched purchase orders and receiving reports adequate to result in a proper cutoff for financial reporting purposes?	____	____	____
15. Is accounts payable detail periodically reconciled with the control accounts at reasonable intervals?	____	____	____
16. Are vendors' statements reviewed for overdue items and reconciled with accounts payable detail?	____	____	____
17. Is there independent follow-up of such matters as overdue items on vendors' statements, payment requests, and complaints?	____	____	____
18. Are employee expense accounts			
a. Prepared in accordance with criteria set by management?	____	____	____
b. Submitted promptly?	____	____	____
c. Adequately supported?	____	____	____
d. Approved before payment?	____	____	____

B. Payroll

.240 Authorization of Wages, Salaries, Withholdings, and Deductions Objectives

Objectives

- Employees are hired and retained only at rates, benefits and perquisites determined in accordance with management's (board of directors, if appropriate) general or specific authorization.
- Payroll withholdings and deductions are based on evidence of appropriate authorization.

Questions—Control Policies and Procedures

	Yes	No	N/A
1. Are all new hires, rates of pay and changes thereto, changes in position, and separations based on written authorizations in accordance with management's criteria?	____	____	____

(Management's criteria, for example, may include—
(i) support for such authorizations by written personnel requisitions which have been initiated and approved at designated levels of management,

	Yes	No	N/A
(ii) conformity of pay rates with previously approved wage and salary schedules, and (iii) appropriate investigation of the job candidate's background.)			
2. Are methods for determining premium pay rates for such matters as overtime, night shift work, and production in excess of certain quotas based on written authorization in accordance with management's criteria?	___	___	___
(Such written authorization may, for example, consist of a schedule based on a labor agreement and/or management policy statements.)			
3. Are all employee benefits and perquisites granted in accordance with management's authorization?	___	___	___
(Employee benefits may be generally authorized as, for example, under a pension plan applicable to a number of employees or specifically authorized as in a deferred compensation agreement with a particular individual authorized by the board of directors.)			
4. Are appropriate written authorizations obtained from employees for all payroll deductions and withholding exemptions?	___	___	___
5. Are personnel files maintained on individual employees which include appropriate written authorizations for rates of pay, payroll deductions, and withholding exemptions?	___	___	___
6. Are the following reported promptly to employees who perform the payroll processing function:			
a. Wage and salary rates resulting from new hires, rate changes, changes in position, and separations?	___	___	___
b. Changes in authorized deductions and withholding exemptions?	___	___	___

.250 Preparation and Recording

Objectives

- Compensation is made only to company employees at authorized rates and for services rendered (hours worked, piecework, commissions on sales, etc.) in accordance with management's authorization.
- Gross pay, withholdings, deductions, and net pay are correctly computed based on authorized rates and services rendered and properly authorized withholding exemptions and deductions.
- Payroll costs and related liabilities are correctly accumulated, classified, and summarized in the accounts in the appropriate period.
- Comparisons are made of personnel, payroll, and work records at reasonable intervals for timely detection and correction of errors.

Questions—Control Policies and Procedures

	Yes	No	N/A
1. Do employees who perform the payroll processing function receive timely notification of:			
a. Wage and salary rates resulting from new hires, rate changes, changes in position, and separations?	___	___	___
b. Changes in authorized deductions and withholding exemptions?	___	___	___
2. Is gross pay determined using authorized rates and:			
a. Time or attendance records for employees paid by the hour or by salary?	___	___	___
b. Piecework records for employees whose wages are based on production?	___	___	___
c. Adequate detail records of sales for commission salesmen?	___	___	___
3. Is there a suitable chart of accounts and established guidelines for determining account distributions for wages and salaries and controlling liabilities for payroll deductions and taxes withheld?	___	___	___
4. Do records of individual employee time, piecework, and/or commissions on sales—			
a. Permit computation of gross pay in accordance with management's criteria?	___	___	___
b. Include adequate information for distribution of payroll costs or reconciliation with payroll costs charged to particular cost centers in accordance with management's criteria?	___	___	___

	Yes	No	N/A
c. Receive written approval of applicable supervisors or foremen before submission to persons who prepare the payroll?			
(Management criteria for determination of gross pay may include such additional considerations as formulas for overtime premium, shift differential premiums and incentive bonuses. In some situations, records of employee time or production may involve charges to several job order or departmental cost centers. Management criteria may also include additional approvals of time or production increments which result in pay over and above certain base amounts.)			
5. Are total production hours used for determination of gross pay reconciled with production statistics used for cost accounting purposes?			
6. Are piece rate records reconciled with production records, or are counts spot checked?			
7. Are salesmen's commission records reconciled with recorded sales?			
8. Are clerical operations in the preparation of payrolls verified by reperformance or reconciliation with independent controls (such as predetermined totals for gross pay and/or net pay) over source data?			
9. Is a reconciliation prepared of:			
a. Payroll cost distributions to gross pay?			
b. Net pay, deductions and withholding to gross pay?			
10. Are comparisons made at reasonable intervals of pay rates per the payroll with rates per the written authorizations in the personnel files by responsible persons whose duties are independent of the personnel, payroll processing, disbursement, and general ledger functions?			
11. Are such data as hours worked, piecework, and commission sales used to determine gross pay compared at reasonable intervals with applicable production and sales records by responsible persons whose duties are independent of personnel, timekeeping, payroll processing, disbursement, and general ledger functions?			
12. Are the results of comparisons made per items 10 and 11 above reviewed by a responsible official and appropriate action taken?			

.260 Disbursements (Payroll) [2]

Objective

- Net pay and related withholdings and deductions are remitted to the appropriate employees and entities respectively, when due.

Questions—Control Policies and Procedures

	Yes	No	N/A
1. Are payrolls approved in writing by responsible employees before issuance of payroll checks or distribution of cash for net pay?			
2. Is net pay distributed by persons who are independent of personnel, payroll preparation, time-keeping, and check preparation functions?			
3. For payrolls paid by check:			
a. Are checks drawn on a separate imprest account?			
b. Are deposits equal to the amount of net pay?			
4. For payrolls paid in cash:			
a. Are adequate security precautions taken?			
b. Does the cash requisition equal the amount of net pay to be distributed as cash?			
c. Is distribution made by persons independent of payroll preparation functions?			
d. Are receipts obtained from employees?			
5. Is responsibility for custody and follow-up of unclaimed wages assigned to a responsible person independent of personnel, payroll processing, and cash disbursements functions?			

[2] See AAM section 4400.280—.300 (or 4400.520—.540) for additional objectives and questions on cash disbursements.

	Yes	No	N/A
6. Are procedures adequate to result in timely and accurate preparation and filing of payroll tax returns and payment of accumulated withholdings and related accrued taxes?			
(Examples of procedures include use of a tax calendar or tickler file, instructions and tables for tax return preparation, use of competent tax information services, and appropriate account classifications and subsidiary records to accumulate required information.)			
7. Are procedures adequate to result in timely and accurate remittance of accumulated payroll deductions for fringe benefits?			
(Examples include timely availability of information on benefit plans and amendments, use of a payment calendar or tickler file, appropriate account classifications and subsidiary records to accumulate required information.)			

.270 Segregation of Functions and Physical Safeguards

Objectives

- Functions are assigned so that no single individual is in a position to both perpetrate and conceal errors or irregularities in the normal course of his duties.
- Access to personnel and payroll records is limited to minimize opportunities for errors and irregularities.

Questions—Control Policies and Procedures

	Yes	No	N/A
1. Is there adequate separation of duties among employees who perform the following functions:			
a. Written authorization of new hires, pay rates and changes thereto, benefits, changes in position, and separations?			
b. Maintenance of personnel records?			
c. Timekeeping and accumulation of piecework and/or commission information?			
d. Preparation of payrolls?			
e. Approval of payrolls?			
f. Cash disbursements?			
g. General ledger?			
2. Do the personnel and payroll records appear reasonably safeguarded?			
(Examples include locked file cabinets, work areas with limited access.)			

C. Cash Disbursements [3]

.280 Assignment of Functions

Objective

- Functions are assigned so that no single individual is in a position to both perpetrate and conceal errors or irregularities in the normal course of his duties.

Questions—Control Policies and Procedures

	Yes	No	N/A
1. Is the cash disbursements function performed by persons who are independent of the following functions:			
a. Purchasing?			
b. Receiving?			
c. Invoice processing?			
d. Payroll preparation and approval?			
e. Shipping?			
f. Accounts receivable?			
g. Cash receipts?			
h. General ledger ?			

[3] The illustrative internal control objectives and questions for the cash disbursements sections of the expenditures cycle (AAM section 4400.280—.300) are duplicated in AAM section 4400.520—.540 because some accountants may prefer to consider them as part of a financing (treasury) cycle.

	Yes	No	N/A
2. Is there adequate separation of duties within the cash disbursement function among persons who perform the following:			
a. Control access to unissued checks?			
b. Prepare checks?			
c. Sign checks and inspect support?			
d. Mail checks?			
e. Maintain custody of petty cash?			
f. Maintain the cash disbursement journal?			
g. Reconcile the bank accounts?			

.290 Processing Disbursements

Objectives

- Disbursements are made only for expenditures incurred in accordance with management's authorization.
- Adjustments to cash accounts are made only in accordance with management's authorization.
- Disbursements are recorded at correct amounts in the appropriate period and are properly classified in the accounts.
- Access to cash and cash disbursements records is restricted to minimize opportunities for irregular or erroneous disbursements.

Questions—Control Policies and Procedures

	Yes	No	N/A
1. Are all bank accounts authorized by the board of directors?			
2. Are all check signers authorized by the board of directors?			
3. Are banks promptly notified of any changes in authorized check signers?			
4. Are banks instructed not to cash checks and other instruments (for example, drafts, money orders, etc.) drawn to the order of the company?			
5. Are all bank accounts and cash funds subjected to general ledger control?			
6. Are all disbursements and bank transfers based on vouchers and check requests which have been approved by responsible employees designated by management?			
7. Are all disbursements except from petty cash made by check?			
8. Are properly approved supporting documents (processed invoices, purchase orders, receiving reports, etc.) presented with the checks and reviewed by the check signer(s) before signing the checks?			
9. Is a mechanical check protector used to inscribe amounts on checks as a precaution against alteration?			
10. Are supporting documents for checks properly cancelled to avoid duplicate payment?			
11. Are signed checks independently mailed directly after signing without being returned to persons involved in the invoice processing and check preparation functions?			
12. Is access to unissued checks limited to designated responsible employees who are independent of the check signing function, including operation of mechanical check signing machines?			
13. Are checks pre-numbered and all numbers accounted for?			

	Yes	No	N/A
14. Are all voided checks retained and mutilated?			
15. Are all checks promptly recorded when issued and listed in detail (cash disbursements journal, check register, etc.)?			
16. Are details of individual disbursements balanced with the totals to be posted to appropriate general ledger account distributions and to total disbursements to be posted to the general ledger control accounts for cash?			
17. Is there a written policy which prohibits:			
a. Drawing checks payable to cash or bearer?			
b. Signing or countersigning of blank checks?			
18. If dual signatures are required:			
a. Are the two signers independent of one another?			
b. Does each signer determine that the disbursement is supported by approved documentation?			
19. If a check signing machine is used:			
a. Are checks approved before mechanical signing by designated responsible employees who are subject to the same segregation of duties as if they were authorized check signers?			
(Use of a check signing machine allows an entity to delegate authority for approving checks to a greater number of persons than those registered with the bank as authorized signers. However, approval procedures should be sufficient to assure the official whose name is on the signature plate that all mechanically signed checks would have met his approval if he had reviewed and manually signed them himself.)			
b. Are the keys, signature plate, and operation of the signing machine under control at all times of the official whose signature is on the plate?			
c. Are the employees who have custody of the keys, plate, and operate the check signing machine independent of voucher and check preparation functions and denied access to blank checks?			
d. Are the checks issued to the machine operator(s) counted in advance and reconciled with the totals of the counting device on the check signing machine by someone other than the machine operator?			
(Control may be strengthened by having a locked compartment on the machine which receives the signed checks and can be opened only by someone independent of the machine operator.)			
20. Are cash funds on an imprest basis and:			
a. Kept in a safe place?			
b. Reasonable in amount?			
c. Controlled by one custodian who is independent of invoice processing, check signing, general accounting, and cash receipts functions?			
d. Periodically counted by someone other than the custodian?			
21. Are all disbursements from cash funds:			
a. Supported by vouchers which are prepared in ink?			
b. Approved in accordance with management's authorization?			
c. Cancelled to prevent reuse?			
d. Subject to a predetermined maximum dollar limit for any individual disbursement?			
22. Are reimbursements of cash funds:			
a. Subject to the same review and approval as processed invoices? (See AAM section 4400.230 on invoice processing)			

	Yes	No	N/A
b. Remitted by checks drawn payable to the order of the custodian of the cash fund?			

.300 Bank Reconciliations

Objective

- Comparison of detail records, control accounts, and bank statements are made at reasonable intervals for detection and appropriate disposition of errors or irregularities.

Questions—Control Policies and Procedures

	Yes	No	N/A
1. Are the bank accounts reconciled monthly by an employee(s) who is independent of invoice processing, cash disbursements, cash receipts, petty cash, and general ledger functions?			
2. Are bank statements, related paid checks, debit and credit memos received directly from the bank by the employee(s) performing the reconciliations?			
3. Does the bank reconciliation procedure include:			
a. Reconciliation of the balance per bank to balance per the general ledger control account and subsidiary detail records?			
b. Comparison in detail of deposits per the bank statement with deposits per cash receipts detail records?			
c. Comparisons in detail of disbursements per bank with the cash disbursements journal (check register) as to date drawn, payee, and amount?			
d. Comparison of payees with endorsements?			
e. Follow up of reconciling items and initiation of entries to record such transactions as checks returned for insufficient funds and bank charges?			
4. Are old outstanding checks investigated and subjected to proper disposition (in compliance with applicable escheat laws if present)?			

V. Production (Conversion) Cycle

A. Production Costs and Inventories

.310 Authorization of Production Activities, Planned Inventory Levels, and Service Capabilities

Objective

- All production activity (including planned inventory levels and service capabilities) and accounting therefor is determined in accordance with management's general or specific authorization.

Questions—Control Policies and Procedures

	Yes	No	N/A
1. Are the types and quantities of goods to be manufactured and/or services to be provided determined in accordance with management's authorization?			

(Some examples of how management may record and communicate its authorization include approval of:

(i) Production goals and schedules based on accompanying sales forecasts.

(ii) Overall production and inventory control plans.

(iii) Establishment of a production control function.

(iv) Definitions and policy statements on services to be provided.)

	Yes	No	N/A
2. Are the methods and materials to be used determined in accordance with management's authorization?			

(Some examples of how management may evidence its authorization include approval of:

(i) Product engineering plans and specifications.

(ii) Acquisitions and use of property and equipment.

Yes | No | N/A

(iii) Procedural instructions for services to be provided.)

3. Are planned inventory levels or service capabilities to be maintained determined in accordance with management's authorization?

   (Some examples of how management may evidence its authorization include approval of:

   (i) Budgeted inventory levels.

   (ii) Policies on whether to produce for specific customer orders, for stock, or a combination of both.

   (iii) Predetermined reorder points.

   (iv) Policies on identification and disposition of excess or obsolete inventory.

   (v) Planned personnel rosters of individuals with specific knowledge, experience, and skills relating to services to be provided.)

4. Is the scheduling of goods to be produced and/or services to be provided determined in accordance with management's authorization?

   (Some examples of how management may evidence its authorization include approval of:

   (i) Production schedules and forecasts.

   (ii) Forecasts of time requirements.

   (iii) Policies and procedures for budgeting individual job or project orders.)

5. Are all adjustments to inventory and cost of sales made in accordance with management's authorization?

6. Are all dispositions of obsolete or excess inventory or scrap made in accordance with management's authorization?

.320 Recording Resources Used in Production and Completed Results

Objective

- Resources obtained and used in the production process and completed results are accurately recorded on a timely basis.

Questions—Control Policies and Procedures

1. Are receiving reports prepared which include adequate information for posting detailed inventory records and allow for summarization into a source for posting inventory control accounts?

   (See AAM section 4400.220, Expenditures Cycle—Receiving, for further illustrative questions on receiving reports.)

2. Are all releases from storage of raw materials, supplies, and purchased parts inventory based on approved requisition documents which:

   a. Include adequate information to be used as a reliable and consistent source for posting detailed inventory records?

      (For example, descriptions, quantities and inventory cost.)

   b. Allow for summarization into a source for maintaining inventory control accounts?

   c. Provide a means (such as pre-numbering or batching) of accounting for all requisitions issued?

3. Is authority to approve inventory requisitions assigned to responsible employees whose duties do not include the following:

   a. Physical custody of raw materials, supplies, and purchased parts inventories?

   b. Maintenance of detailed inventory records?

   c. Maintenance of inventory control accounts?

	Yes	No	N/A
4. Is labor effort (time, cost or both) reported promptly and recorded in sufficient detail to be identified with applicable classifications such as job orders or allocation to units in process, and to provide for:			
a. Accumulation into reliable and consistent sources for maintaining detail production control and cost accounting records?	___	___	___
b. Summarization into a source for posting inventory control accounts?	___	___	___
c. Reconciliation with payroll costs charged to the production process?	___	___	___
d. A means (such as pre-numbering or batching) of accounting for all labor reports issued?	___	___	___
(See AAM section 4400.240—.270, Expenditures Cycle—Payrolls, for further illustrative questions on payroll.)			
5. Are transfers of completed units from production to custody of finished goods inventory based on approved completion reports which authorize such transfer and:			
a. Include adequate information to be used for reliable and consistent maintenance of detailed finished goods inventory and reconciliation with applicable materials and labor put into the production process?	___	___	___
b. Allow for summarization into a reliable and consistent source for maintaining general ledger control accounts?	___	___	___
c. Provide a means (such as pre-numbering or batching) of accounting for all completion reports issued?	___	___	___
6. Do completion reports include indication of approval by designated individuals in accordance with management's criteria?	___	___	___
(Such criteria may concern completion of prescribed production steps and conformity with prescribed quality standards.)			
7. Are there adequate procedures for reporting defective units and scrap resulting from the production process?	___	___	___
8. Are perpetual inventory records maintained of both quantities and dollar amounts for:			
a. Raw materials?	___	___	___
b. Supplies?	___	___	___
c. Work in process?	___	___	___
d. Finished goods?	___	___	___
e. Scrap?	___	___	___
f. Inventory held by outside parties?	___	___	___
(For example, bonded warehouses, consignees, subcontractors, suppliers.)			
g. Inventory held for outside parties?	___	___	___
(For example, goods billed but not yet shipped, goods held on consignment, materials being processed as a subcontractor, etc.)			
9. Are the perpetual records of inventory detail:			
a. Controlled by general ledger accounts?	___	___	___
b. Based on documentation of inventory movement and adjustments which has been approved in accordance with management's authorization?	___	___	___
c. Adjusted to periodic physical inventories taken annually or on a cycle basis at least once a year?	___	___	___
d. Reconciled with the inventory control accounts at reasonable intervals?	___	___	___
e. Kept by persons whose duties do not include the following:			
(1) Custody of the physical stock	___	___	___
(2) Maintenance of the general ledger control accounts	___	___	___

	Yes	No	N/A
(3) Authority to requisition withdrawals or other movement of inventory.			
10. Is documentation of inventory movement accounted for to determine complete and adequate recording thereof?			
11. Are there adequate procedures for identifying and reporting excess, slow-moving, and obsolete inventories?			
12. Do the duties of the persons engaged in production, inventory planning, and inventory custody exclude the following functions:			
a. Maintenance of detail inventory records?			
b. Cost accounting?			
c. General accounting?			

.330 Recording Transfers to Customers and Other Inventory Dispositions

Objective

- Transfer of finished production to customers and other dispositions such as sales of scrap are accurately recorded on a timely basis.

Questions—Control Policies and Procedures

	Yes	No	N/A
1. Are releases of finished goods inventory for delivery to customers based on shipping documents which have been approved in accordance with management's authorization?			
(See AAM section 4400.170, Revenue Cycle—Shipments, for further illustrative questions on shipping documents.)			
2. Are releases of excess, obsolete, defective or scrap inventory for disposition based on documented instructions which have been approved in accordance with management's authorization?			
3. Is authority to approve instructions for the release of inventory assigned to responsible employees whose duties do not include the following:			
a. Physical custody and handling of inventories including preparation of goods for shipment?			
b. Maintenance of detailed inventory records?			
c. Maintenance of general ledger control accounts?			
4. Do shipping documents and release documents for such other dispositions as sales of scrap—			
a. Include adequate information for recording reductions in the detailed inventory records, charges to cost of sales, and cross-reference or connection with source documents used to recognize revenue and the related receivable?			
(If practicable, the same document may serve as the source for recognition of revenue and the related receivable and of cost of sales and the related reduction of inventory.)			
b. Allow for summarization into a source for maintaining the inventory control accounts?			
c. Provide a means (such as pre-numbering or batching) of accounting for all shipping documents and other release documents issued?			

.340 Accumulation and Classification of Production and Inventory Costs and Costs of Sales

Objective

- Inventory, production costs, and costs of sales are accumulated and classified in the accounts to—

  (1) permit preparation of statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements.

Yes | No | N/A

(2) maintain accountability for costs incurred.

Questions—Control Policies and Procedures

1. Do the chart of accounts and standard journal entries provide adequate general ledger control accounts and subsidiary detail for the following:
   a. Accumulation and classification of costs of materials, direct labor, and overhead (including indirect labor)? ____ ____ ____
   b. Accumulation of information such as the following in sufficient detail and with proper cutoff to provide for adequate determination of inventory costs and cost of goods sold:
      (1) Quantities of raw materials and supplies used in production? ____ ____ ____
      (2) Labor hours and/or machine hours expended? ____ ____ ____
      (3) Quantities or units of product produced? ____ ____ ____
      (4) Quantities or units of product transferred to customers? ____ ____ ____

      (Accounts and records vary extensively among companies because of such variables as industry, company size, and nature of the production or service process. Examples of techniques to consider in addressing a company's needs include:
      (I) Identification and allocation of costs directly to units or jobs produced and to overhead; application of overhead to units or jobs using a burden rate and a factor such as direct labor hours incurred or units produced.
      (ii) Use of a job order or process cost system or combination of both, or an allocation of costs incurred to units produced based on units sold and the units in the physical inventories as of the closing and opening of a period.
      (iii) Identification of costs incurred with departments or cost centers responsible for incurring the particular costs.
      (iv) Use of departmental or cost center burden rates to apply overhead to production.
      (v) Use of a standard cost system with investigation of variances.
      (vi) Account classifications which provide for preparation of reports and statements in conformity with generally accepted accounting principles and, if appropriate, such other criteria as direct costing practices selected by management for internal purposes and statutory accounting practices required by regulatory bodies.)
2. If a cost accounting system is used, is it reconciled at reasonable intervals with the general ledger? ____ ____ ____
3. If perpetual records are maintained, are they reconciled at reasonable intervals with the:
   a. General ledger? ____ ____ ____
   b. Cost accounting system? ____ ____ ____
4. Are requisitions for materials, supplies, finished goods, and physical transfers of inventory subjected to the following:
   a. Review to determine that requisitions are completed and approved in accordance with management's authorization? ____ ____ ____
   b. Accounting for all requisitions used? ____ ____ ____

      (For example, by accounting for all numbers pre-assigned to particular types of requisition forms.)
   c. Summarization of requisitions at reasonable intervals for consistent and timely maintenance of control accounts? ____ ____ ____
   d. Accurate and timely recording in the subsidiary detail records? ____ ____ ____
5. Are reports of direct and indirect labor effort (for example: job tickets, time cards, etc.) subjected to the following:
   a. Review to determine that the reports are completed and approved in accordance with criteria authorized by management? ____ ____ ____

	Yes	No	N/A
b. Accounting for all reports issued?			
(For example, by accounting for all numbers pre-assigned to particular types of reporting forms.)			
c. Reconciliation with account distribution of payroll for consistent and timely maintenance of the control accounts?			
d. Accurate and timely recording in the subsidiary detail records?			
6. Are the detailed inventory records and control accounts adjusted for reports of excess, slow-moving, and obsolete inventories in accordance with management's general or specific authorization?			
7. Are burden rates and amounts of overhead applied to production compared at reasonable intervals with actual overhead costs incurred and updated in accordance with management's authorization?			
8. For standard cost systems:			
a. Are standard rates and volume compared at reasonable intervals with actual costs and activity and revised accordingly for changes in underlying conditions?			
(For example, comparison of raw material costs with vendors' invoices, standard labor rates with actual rates, standard materials usage and machine hours with product engineering changes, standard labor hours with time studies, etc.)			
b. Are significant variances investigated and the resulting explanation brought to management's attention on a timely basis?			
9. Do the duties of persons who maintain the detailed inventory and cost accounting records exclude the following functions:			
a. Physical custody and handling of inventories?			
b. Maintenance of the general ledger control accounts?			
10. Is access to the detailed inventory records and control accounts limited to persons responsible for their maintenance, oversight, and internal audit?			
11. Are the inventory detail records and control accounts adjusted to physical counts at least annually?			

.350 Inventory Safeguarding

Objectives

- Inventory is protected from unauthorized use or removal.
- Access to inventory, property, cost, and production records is limited to designated individuals in accordance with management authority so that unauthorized dispositions may be prevented or detected within a timely period.

Questions—Control Policies and Procedures

	Yes	No	N/A
1. Do physical safeguards of inventory appear reasonably adequate in relation to the materiality of the inventory and its susceptibility to theft?			

(Examples include:

- Fenced areas,
- Restricted-access storerooms or vaults,
- Guards,
- Detection and scanning devices (for example, alarms, television cameras),
- Inspection of personnel,
- Independent storeroom clerks,

	Yes	No	N/A
• Maximum visibility by supervisors and security personnel of work and storage areas.)			
2. Does inventory appear reasonably protected from physical deterioration?			
(Examples include:			
• Shelters and buildings,			
• Maintenance of environment at appropriate temperature and humidity,			
• Containers and storage facilities.)			
3. Are persons responsible for custody of inventory independent of inventory recording, cost accounting, and general accounting functions?			
4. Is insurance coverage of the inventory maintained and reviewed in accordance with management's authorization?			

.360 Physical Counts of Inventory

Objective

- Recorded balances of inventory are substantiated and evaluated at reasonable intervals by comparison with and evaluation of actual quantities on hand. (For example, physical counts and review for excess, slow-moving, and obsolete stock.)

Questions—Control Policies and Procedures

	Yes	No	N/A
1. Is inventory subjected to physical count at least annually?			
2. If the complete physical count is made at other than the fiscal year end are the controls over physical movement (receipts, internal transfers, and shipments) of inventory, accuracy of recording cutoffs and segregation of duties satisfactory for such timing?			
3. If counts are made on a cycle basis rather than as complete counts, are all of the following conditions present for classes of inventory subjected to cycle counts?			
a. Complete and accurate perpetual records which are maintained on a timely basis?			
b. The nature of the inventory items allows for practicable comparison with perpetual records?			
c. Adequate control over physical movement of inventories (receipts, internal transfers, and shipments) and accurate recording of cutoffs to provide timely and accurate source data for maintaining the perpetual records and clear identification of classes or groups of items to be counted?			
d. Sufficient segregation of duties so that errors of omission or commission are prevented or detected promptly?			
4. Do detailed written inventory procedures and instructions exist which have been approved in accordance with management's authorization before issuance and use?			
5. Do the inventory procedures adequately address the following matters:			
a. Location and orderly physical arrangement of inventories?			
b. Identification and description of the inventories by persons familiar with it?			
c. Segregation and proper identification of goods that are not property of the client, such as customers' goods and goods held on consignment?			
d. Method of determining quantities such as weight, count or measure?			
e. Recording of items on count sheets or tickets including complete descriptions, identifying codes (serial numbers, model numbers), as well as quantities counted?			
f. Special considerations for work in process such as identifying stage of completion?			
g. Identification of stock counted to determine whether all items are counted and to preclude duplicate counting?			
h. Cutoff of receipts, internal transfers, and shipments?			

	Yes	No	N/A
i. Control of physical inventory records, such as pre-numbering of all count sheets, count tickets, and accounting for all numbered records issued and used?			
j. Identification of slow-moving, obsolete, and damaged items?			
k. Substantiation of inventories held by others?			
l. Pricing, extension, and summarization of the physical counts?			
m. Investigation and disposition of differences between physical counts and detailed inventory records?			
6. Are physical count procedures supervised by a responsible official whose duties do not include physical custody of inventories and performance of purchasing, receiving, and shipping functions?			
7. Are inventory instructions adequately communicated to and understood by persons who perform the physical counts?			
8. Are physical counts performed by persons whose duties do not include the following:			
a. Physical custody of inventories?			
b. Detailed inventory record keeping (maintaining perpetual records)?			
c. Maintenance of inventory control account(s)?			
9. Is inventory movement adequately controlled during the count so that items are not missed or double-counted because of:			
a. Receiving activity?			
b. Internal inventory movement?			
c. Shipping activity?			
10. Are controls over purchases and receiving activity sufficient to result in recording of liabilities for any items included in inventory which have not been paid for?			
11. Are controls over sales and shipping activity sufficient to result in exclusion from the physical inventory of any items which have been sold and billed but not yet shipped?			
12. Are inventory counts subject to adequate verification such as recounts by persons other than those who made the initial counts or spot checks by others, such as internal auditors?			
13. Are pricing, extension, and summarization of the physical counts performed by persons whose duties do not include the following:			
a. Physical custody of inventories?			
b. Detailed inventory record keeping?			
c. Maintenance of the inventory control accounts?			
14. Are pricing, extension, and summarization of the physical counts subject to adequate verification such as reperformance by persons other than those who initially performed the tasks on a complete or test basis?			
15. Are differences between physical counts and detailed inventory records investigated in accordance with management's authorization before the records are adjusted?			
16. Is there documentation of review and analysis of the physical inventory to:			
a. Conform with the lower of cost or market principle,			
b. Identify items which are excessive, slow-moving, defective or obsolete,			
c. Determine the need for adjustments or valuation allowances?			
17. Are adjustments of the inventory detail records and control accounts given prior approval in accordance with management's authorization?			
18. Are dispositions of obsolete or excess inventories and scrap made in accordance with criteria authorized by management?			

B. Property and Equipment

.370 Initiation and Execution of Property and Equipment Transactions

Yes No N/A

Objective

- Additions and related accumulation of depreciation or amortization, retirements, and dispositions of property and equipment (owned and leased) are made in accordance with management's authorization.

Questions—Control Policies and Procedures

1. Is advance approval in accordance with management's criteria required for all property and equipment transactions? ____ ____ ____

   (For significant additions (purchases or leases) approval authority may be kept at such levels as the board of directors. In some closely held entities, authority for such approval may be reserved by the stockholders or partners. Some entities, however, may have a framework of policies and procedures within which general authority for property and equipment transactions within certain dollar limits may be delegated to management levels below the board of directors. It is desirable that such policies be clearly expressed and documented.)

2. Are requests for additions, transfers, major maintenance and repair, retirement and disposition of property and equipment—

   a. Initiated by designated individuals in accordance with management's authorization? ____ ____ ____

      (These individuals generally are responsible employees or officials in the department which would use the asset.)

   b. Formally documented, including an adequate description of the proposal, its reasons, and the estimated amount of the transaction? ____ ____ ____

      (Some entities may use standardized forms to document requests for property and equipment transactions including signatures of employees who initiated and approved the request.)

   c. Reviewed for key considerations in accordance with management's criteria? ____ ____ ____

      (Key considerations may include such issues as:

      (i) Whether to make or buy the asset.

      (ii) Selection of vendors, prices, and terms including consideration of soliciting competitive bids.

      (iii) Selection among financing alternatives such as use of internally generated funds, entering debt or lease agreements, and issuing preferred or common stock.

      (iv) Accounting matters, such as whether the transaction should be capitalized or expensed, classification of leases, determination of estimated useful life, salvage value, and methods of depreciation or amortization.)

   d. Approval at a higher level than the department or official who initiated the request? ____ ____ ____

3. Are authorizations to execute property and equipment transactions adequately documented? ____ ____ ____

   (Following are some examples of such documentation:

   (i) Decisions recorded in meetings of the board of directors or finance committee accompanied by relevant detailed proposals and cost-benefit analyses which may be part of the minutes by reference.

   (ii) Work order forms approved by designated individuals in accordance with clearly stated management criteria.

   (iii) Contracts and agreements signed by individuals in accordance with appropriately documented designation by the board of directors.)

4. Are procedures adequate for determining that components and services for property and equipment are received or performed? ____ ____ ____

   (Examples include status or completion reports prepared by architects and engineers and approved in accordance with management's authorization; or transactions processed through the company's normal purchasing procedures. See AAM section 4400.210—.230, Expenditures Cycle—Purchases and Accounts Payable, for additional illustrative inquiries on purchase orders, receiving reports and vendors' invoices.)

5. Are procedures adequate for determining that all dispositions of property and equipment have been executed and proceeds, if any, received in accordance with management's authorization? ____ ____ ____

Yes No N/A

.380 Recording Property and Equipment and Related Depreciation and Amortization

Objective

- Transactions involving property and equipment and related depreciation and/or amortization are accurately recorded, accumulated, and classified in detail and in control accounts to—
  (1) permit preparation of statements in conformity with generally accepted accounting principles or other criteria applicable to such statements, and
  (2) maintain accountability for assets.

Questions—Control Policies and Procedure

1. Are detailed records maintained for the classes of property and equipment (owned and leased) which present:
   a. Description of specific assets, their location, and if applicable, such specific identification as serial or other control numbers? ___ ___ ___
   b. Cost, acquisition date, and date placed in service (if different from acquisition date)? ___ ___ ___
   c. Depreciable or amortizable life and method of depreciation or amortization? ___ ___ ___
      (1) For financial reporting purposes? ___ ___ ___
      (2) For tax purposes if different from financial reporting? ___ ___ ___
   d. Estimated salvage value and amount subject to depreciation or amortization? ___ ___ ___
   e. Amount of related accumulated depreciation or amortization? ___ ___ ___
2. Are general ledger control accounts maintained for the appropriate classes of owned and leased property and equipment and related depreciation and amortization? ___ ___ ___
3. Are responsibilities for maintaining the detailed property records segregated from those of—
   a. Maintaining the general ledger control accounts? ___ ___ ___
   b. Custody of property and equipment? ___ ___ ___
4. Do persons who maintain the detail records and control accounts receive timely and adequate information about—
   a. Additions, transfers, retirement from service, and dispositions of property and equipment? ___ ___ ___
   b. Depreciable (or amortizable) lives and methods of depreciation or amortization as prescribed in accordance with management's authorization? ___ ___ ___
5. Are the detailed property and equipment records reconciled at reasonable intervals with the control accounts and differences, if any, investigated and resolved in accordance with management's authorization? ___ ___ ___
6. Are depreciable and amortizable lives reviewed at reasonable intervals for adequacy in relation to use or obsolescence based on actual experience? ___ ___ ___

.390 Safeguarding Property and Equipment

Objective

- Property and equipment is reasonably safeguarded from loss.

Questions—Control Policies and Procedures

1. Is property and equipment insured in accordance with management's authorization based on appraisals made at reasonable intervals? ___ ___ ___
2. Are items of property and equipment (owned and leased) subject to reasonably adequate physical protection techniques? ___ ___ ___

   (Examples of such techniques include fire alarms and extinguishers, fences, security guards, burglar alarms, limited access, and requisitioning procedures for use of portable equipment, etc.)
3. Is responsibility for physical custody of property and equipment assigned to employees whose duties are independent of:
   a. Maintaining detailed property records? ___ ___ ___

	Yes	No	N/A
b. General ledger functions?	____	____	____
4. Are items of property and equipment (owned and leased) physically inspected at reasonable intervals and compared with the detailed property records?	____	____	____
(This may be done in coordination with appraisals made to determine insurable values.)			
5. Are documents of title and property rights, such as deeds and leases, in the custody of a responsible employee whose duties do not include maintenance of the detailed property records or physical custody of the assets?	____	____	____
6. Are documents of title and property rights compared with the detailed property records at reasonable intervals by persons whose duties do not include the following:			
a. Custody of such documents?	____	____	____
b. Maintenance of the detailed property and equipment records?	____	____	____

VI. Financing (Treasury) Cycle

A. Investments

.400 Authorization of Investment Transactions

Objective

- The nature and terms of investment transactions (marketable securities, notes receivable, and long-term debt or equity investments) are made in accordance with management's authorization.

Questions—Control Policies and Procedures

	Yes	No	N/A
1. Are investment transactions initiated and approved in accordance with management authorization?	____	____	____
(If investments are infrequent and significant, management may deal with each purchase or sale on a case by case basis with approval exercised by the board of directors or a finance committee. If investment transactions are relatively frequent, management may establish standard policies and procedures for initiation and approval of investment transactions.)			
2. Are investment transactions approved before execution by responsible officials other than those who proposed the transactions?	____	____	____
(For example, a transaction may be proposed by the chief executive officer and executed after authorization and approval by the board of directors. Another example would be purchases of treasury bills by the chief financial officer pursuant to authorization by the board of directors.)			
3. Are investment transactions initiated and approved by persons whose duties do not include:			
a. Accounting for investment transactions?	____	____	____
b. Custody of investment securities?	____	____	____
4. Are initiation and approval of investment transactions adequately documented?	____	____	____
5. Are brokers advices and other evidence of execution of transactions promptly compared with documented authorizations and differences brought to the timely attention of management?	____	____	____

.410 Recording and Classifying Investment Transactions

Objective

- Investment transactions, including accrual and collection of related income, are recorded at the correct amounts in the accounting periods in which they were executed or earned, and properly classified in the accounts.

Questions—Control Policies and Procedures

	Yes	No	N/A
1. Are adequate general ledger control accounts maintained for various investment classifications and related income?	____	____	____

	Yes	No	N/A
2. Are adequate detailed investment records maintained currently including control of related income?			
3. Are procedures adequate to determine that investment income (interest, dividends) is properly accrued and promptly collected?			

(Examples of these procedures include comparison of interest accrued with terms of the securities or loan agreements and interest income received, or comparison of dividend income with published dividend records or reports by the investee.)

	Yes	No	N/A
4. Are the detailed investment records reconciled with the general ledger control accounts, including related income, by persons whose duties do not include:			
a. Maintenance of the detailed investment records?			
b. Maintenance of the general ledger?			
c. Physical custody of the investment securities?			
5. Are investments and related collateral reviewed and appraised or valued at market at reasonable intervals for comparison with cost valuations and—			
a. Reporting of the findings to management?			
b. Determination of need for any valuation allowances?			

.420 Physical Safeguards and Custodial Accountability

Objective

- Documents evidencing ownership of investments and related collateral, and other investment records are subjected to reasonably adequate physical safeguards and effective custodial accountability procedures.

Questions—Control Policies and Procedures

	Yes	No	N/A
1. Are investment securities and related collateral subject to reasonably adequate physical safeguards?			

(Examples include use of safe deposit boxes and/or vaults which require two individuals to gain access; custodial accounts with banks and trust companies, and accounts with brokers.)

	Yes	No	N/A
2. Are investment securities, except for bearer securities, registered in the name of the company or nominees designated in accordance with management's authorization?			
3. If an independent custodian is used, has the custodian been approved by the board of directors?			
4. Is custody of investment securities held by the company assigned to designated bonded employees whose duties do not include:			
a. Maintenance of detailed investment records?			
b. Maintenance of general ledger control accounts?			
c. Cash receipts and disbursement functions?			
5. Is authority to withdraw investment securities from custody limited to written authorization and joint signatures of responsible officials whose duties do not include:			
a. Custody of investment securities?			
b. Maintenance of detailed investment records?			
6. Are investment securities examined at reasonable intervals and compared with detailed investment records by responsible persons whose duties do not include:			
a. Custody of the investment securities?			
b. Maintenance of the detailed investment records?			
c. Maintenance of the general ledger control accounts?			
d. Cash functions?			

B. Borrowing (Debt and Leases)

.430 Authorization of Debt and Other Borrowing Arrangements

	Yes	No	N/A

Objective

- All debt and other borrowing arrangements (such as leases) are initiated and executed in accordance with management's authorization.

Questions—Control Policies and Procedures

1. Are debt and other borrowing arrangements initiated and approved in accordance with management authorization? ___ ___ ___
2. Are authorizations for specific debt and other borrowings recorded? ___ ___ ___

   (Authorizations may be recorded, for example, as decisions in the minutes of board of directors' meetings, finance committee meetings, or partners' meetings.)
3. Do the authorizations specify:
   a. The officials authorized to negotiate debt and leases? ___ ___ ___
   b. The maximum commitments such officials can make? ___ ___ ___
   c. Property which may be pledged to collateralize debt? ___ ___ ___
   d. Covenants which may be made to obtain the loan or lease? ___ ___ ___

   (Some entities may require that all loan and other borrowing agreements be reviewed by legal counsel before signing.)
4. Are the signatures of two authorized officials required to execute debt instruments or leases? ___ ___ ___
5. Do procedures appear adequate for initiating proposed debt and lease transactions? ___ ___ ___

   (In some entities, debt and lease transactions may be infrequent and of such significance that management participates directly in the proposal and approval process on a case by case basis using specialized assistance where appropriate. In other entities, there may be regular procedures concerning matters such as:

   (i) Study of alternatives such as debt, lease or equity financing.
   (ii) Review of corporate charter, bylaws, and covenants of existing debt and lease agreements and obtaining appropriate advice from legal counsel.
   (iii) Review of financial forecasts, tax and financial reporting considerations and obtaining appropriate professional advice.)
6. If an agent (generally a bank or trust company) is used for the interest disbursing and redemption functions, have the agent and arrangements been authorized by the board of directors? ___ ___ ___

.440 Recording and Classifying Debt and Other Borrowings

Objective

- Transactions and obligations concerning debt and other borrowing arrangements are promptly and accurately recorded and classified in detail records and control accounts to—
  (a) permit preparation of financial statements including required disclosures in conformity with generally accepted accounting principles or other criteria applicable to such statements, and
  (b) provide timely and accurate information as a basis for conforming with payment obligations and other covenants in the applicable agreements.

Questions—Control Policies and Procedures

1. Are detailed, timely records maintained of such debt and other borrowings as notes payable, long-term debt, and capitalized leases that include such information as:
   a. Date of inception? ___ ___ ___
   b. Type of obligation? ___ ___ ___
   c. Face amount? ___ ___ ___
   d. Interest rate? ___ ___ ___
   e. Maturity? ___ ___ ___

	Yes	No	N/A
f. Timing and amount of payments?			
g. Proceeds initially received?			
h. Payments of principal?			
i. Outstanding principal balance?			
j. Accrued interest expense?			
k. Payments of interest?			
l. Outstanding balance of accrued interest payable?			
m. Premium or discount at inception?			
n. Amortization of premium or discount?			
o. Balance of unamortized premium or discount?			
p. Summarized information or collateral and/or restrictive covenants connected with the obligation (such as minimum current ratios and/or debt to equity ratios; restrictions on paying dividends, purchasing property and equipment, and/or entering lease agreements?			
2. Does the chart of accounts provide adequate control accounts for principal amounts and related interest expenses of debt and other borrowings?			
3. Are the detailed records maintained by responsible person(s) whose duties do not include:			
a. Maintenance of the general ledger control accounts?			
b. Physical custody of agreements connected with borrowings and unissued debt instruments?			
c. Cash functions?			
4. Do persons who maintain the detail records and control accounts receive timely and adequate information about debt and other borrowing obligations (for example, copies or abstracts of the debt and lease agreements)?			
5. Are detailed records reconciled with the control accounts at reasonable intervals by persons whose duties do not include:			
a. Maintenance of the detailed records on debt and other borrowings?			
b. Custody of agreements connected with borrowings and unissued debt instruments?			
6. Are adequate reports developed from the detailed records and actual debt and lease agreements which provide timely and accurate information as a basis for:			
a. Payments of principal and interest in conformity with the agreements?			
b. Monitoring compliance with terms and covenants in the agreements?			
(See AAM section 4400.280, Expenditure Cycle, for illustrative objectives and questions on cash disbursements.)			
7. Are detailed records compared with debt and lease agreements at reasonable intervals by responsible persons whose duties do not include:			
a. Maintenance of the detailed records?			
b. Custody of the debt and lease agreements?			
c. Maintenance of the general ledger control accounts?			
d. Cash functions?			
8. If independent agents are retained for the interest paying and redemption functions, are the agents' reports promptly reconciled with the control accounts and subsidiary records?			

.450 Safeguarding Records, Documents, and Unissued Debt Instruments

Objective

- Access to records, documents, and instruments concerning debt and other borrowing arrangements is permitted only in accordance with management's authorization.

Questions—Control Policies and Procedures

	Yes	No	N/A
1. Does a responsible individual maintain adequate files of copies of notes payable long-term debt, mortgage agreements, and leases?			

	Yes	No	N/A
2. Are unissued debt instruments such as notes and bonds adequately safeguarded and in the custody of a responsible employee whose duties do not include—			
a. Maintenance of detailed records on borrowings and other term obligations?	___	___	___
b. Maintenance of general ledger control accounts?	___	___	___
c. Cash functions?	___	___	___
3. Are unissued debt instruments subject to pre-assigned numerical control and are all such instruments accounted for at reasonable intervals?	___	___	___
4. Are paid bonds and notes effectively cancelled to preclude their further use?	___	___	___

C. Equity Capital

.460 Authorization of Equity Capital Transactions

Objective

- Equity capital transactions are—
  (a) appropriately authorized and approved in conformity with the entity's governing document (corporate charter, partnership agreement, etc.)
  (b) initiated and executed in accordance with management's authorization.

Questions—Control Policies and Procedures

	Yes	No	N/A
1. Are capital transactions (issuance, reacquisition, and redemption of stock, dividends, granting of options, rights, conversion privileges, etc.) authorized and approved in conformity with the entity's governing document?	___	___	___
(The entity's governing document (corporate charter, partnership agreement, etc.) may clearly specify the groups or designated officials who have authority concerning the initiation and approval of specific types of capital transactions.)			
2. Are authorizations and approvals for specific capital transactions appropriately recorded?	___	___	___
(For example, if the corporate charter provides that capital transactions be initiated by the board of directors subject to approval of the stockholders, such authorizations and approvals would be recorded in the respective minutes of board of directors' meetings and stockholders' meetings.)			
3. Are two officials specifically authorized by the board of directors required to sign and countersign stock certificates?	___	___	___
4. Are all stock certificates prepared and approved before issuance in accordance with management's authorization?	___	___	___
(Prescribed procedures would include, for example, compliance with tax and other statutory requirements before signing and issuing certificates. For transfers and retirements of certificates, prescribed procedures would include cancellation and disposition of the certificates received.)			
5. If a registrar, transfer agent and/or dividend paying agent is retained, have they been authorized by the board of directors?	___	___	___

.470 Recording and Classifying Equity Capital Transactions

Objective

- Transactions and obligations concerning equity capital are promptly and accurately recorded and classified in detailed records and control accounts.

Questions—Control Policies and Procedures

	Yes	No	N/A
1. Does the general ledger include appropriate control accounts for equity capital?	___	___	___
2. Are appropriate control records maintained for each class of stock on such information as number of shares authorized, issued and outstanding, and number of shares subject to options, warrants, and conversion privileges?	___	___	___
3. Are timely detailed records maintained on the specific stock certificates issued and outstanding for each class of capital stock and the identity of holders of record and number of shares for each certificate?	___	___	___

Yes No N/A

(In a closely held corporation with a limited number of shareholders and outstanding certificates, properly completed stubs in capital stock certificate books may serve this purpose. Retired certificates would normally be cancelled and reattached to the related stubs. Other situations may require a data base that permits timely rendering of listings of each certificate by number and/or of each shareholder and number of shares held.)

4. Are detailed stock certificate records reconciled at reasonable intervals with the control records and the general ledger? ___ ___ ___

   (If the corporation retains independent agents for the registrar and transfer functions, for example, the agents' periodic reports would be promptly reconciled with the general ledger.)

5. Are reconciliations of detailed records with the control records and general ledger performed by persons whose duties do not include:
   a. Custody of unissued stock certificates? ___ ___ ___
   b. Maintenance of the detailed records? ___ ___ ___
   c. Cash functions? ___ ___ ___

.480 Physical Safeguards and Custodial Procedures

Objectives

- Access to records, agreements, and such negotiable documents as stock certificates concerning equity capital is permitted only in accordance with management's authorization.
- Records, agreements, and negotiable documents are subjected to reasonably adequate physical safeguards and custodial procedures.

Questions—Control Policies and Procedures

1. Are unissued stock certificates, reacquired certificates and detailed stockholder records subject to reasonable physical safeguards? ___ ___ ___

   (Examples include fire-resistant files, vaults, and use of safe deposit boxes.)

2. Are stock certificates subject to controls such as pre-numbering which provides that all certificates (unissued, issued, and retired) may be accounted for? ___ ___ ___
3. Are unissued and retired stock certificates examined and all certificate numbers accounted for at reasonable intervals by a person(s) whose duties do not include:
   a. Physical custody of unissued stock certificates? ___ ___ ___
   b. Maintenance of stockholder detail records? ___ ___ ___
   c. Cash functions? ___ ___ ___
   d. General ledger functions? ___ ___ ___
4. Are retired stock certificates—
   a. Examined for proper endorsement and effectively cancelled by a person(s) whose duties do not include maintenance of the detailed stockholder records? ___ ___ ___
   b. Matched and recorded promptly in the detailed records of certificates (reattached to related stubs in the certificate book)? ___ ___ ___
5. Are treasury stock certificates registered in the name of the company and recorded to be readily distinguished from other outstanding shares? ___ ___ ___

.490 Dividends Disbursements

Objective

- Dividends are disbursed accurately and in conformity with decisions of the board of directors.

Questions—Control Policies and Procedures

1. Are dividends declared recorded in the minutes of the board of directors meetings regarding class of stock, amount per share, total amount, record date, and payment date? ___ ___ ___
2. Do procedures result in an accurate cutoff and accurate listing of stockholders as of the record date? ___ ___ ___
3. Are dividend checks prepared based on appropriate stockholder listings and subjected to the following:

	Yes	No	N/A
a. Approval and signature in accordance with management's authorization?			
b. Mailing by a person(s) whose duties do not include maintenance of detailed records of stockholders, custody of unissued and retired stock certificates, and check preparation functions?			
4. Are total dividends disbursed reconciled to total outstanding shares as of the record date?			

D. Cash [4]

.500 Processing Collections

Objectives

- Access to cash receipts and cash receipts records, accounts receivable records, and billing and shipping records is controlled to prevent or detect, on a timely basis, the taking of unrecorded cash receipts or the abstraction of recorded cash receipts.
- Detail transaction and account balance records are reconciled, at reasonable intervals, with applicable control accounts and bank statements for timely detection and corrections of errors.

Questions—Control Policies and Procedures

	Yes	No	N/A
1. Is the mail opened by a person(s) whose duties do not involve any shipping, billing, accounts receivable detail, general ledger, invoice processing, payroll, and cash disbursement functions?			
2. Does the person(s) who opens the mail:			
a. Place restrictive endorsements on all checks when received so they are for deposit only to the bank accounts of the company?			
b. List or otherwise obtain control (for example, by photocopying) over all remittances and prepare totals at least daily?			
c. Forward all remittances to the person who prepares and makes the daily bank deposit?			
d. Forward the total of remittances to persons, who are independent of physical handling of remittances and accounts receivable detail functions, for subsequent comparison with the authenticated duplicate deposit slip and with control total over postings to subsidiary records?			
(In lock box arrangements, customers would mail their remittances to a post office box controlled by the company's bank which would have responsibility for functions 2a-2d.)			
3. Are receipts of currency controlled by cash registers and/or pre-numbered cash receipt forms?			
a. If cash registers are used, is a copy of the tape given to the customer as a receipt, and:			
(1) Is the key to the cash register tape compartment in the custody at all times of a responsible employee other than the cash register operator(s)?			
(2) Are readings of the register periodically taken and compared with the cashier's records of receipts by a responsible employee other than the cash register operator(s)?			
b. If pre-numbered receipts are used for currency collections:			
(1) Is a copy given to the payor as a receipt?			
(2) Are all prenumbered receipts accounted for by a person(s) other than the person(s) handling cash received and balanced with the daily cash received?			
c. If cash collections are for payments on account, is adequate information given for accurate posting to accounts receivable detail?			

[4] The illustrative internal control structure objectives and related questions for these cash sections are the same as those for the cash receipts sections of the revenue cycle (AAM section 4400.190—.200) and cash disbursements sections of the expenditures cycle (AAM section 4400.280—.300). They are duplicated here in AAM section 4400.500—.540 because some accountants may prefer to consider them as part of a financing (treasury) cycle.

	Yes	No	N/A
d. If significant cash sales are made (as in a retail store) are spot checks made to determine that cashiers are following prescribed procedures?			
4. Are currency receipts forwarded daily to the person who prepares the daily bank deposit?			
5. Is a summary listing of daily currency receipts forwarded to a person(s) independent of physical handling of remittances and accounts receivable detail functions?			
6. Do areas involving physical handling of cash appear reasonably safeguarded? (For example, protective windows, vaults, cashier cages, etc.)			
7. Are each day's receipts (by mail, and over the counter) except for postdated items deposited intact daily?			
8. Are postdated items segregated on daily detail listings of remittances to aid in control of total items received?			
9. Are all employees who handle receipts adequately bonded?			
10. Are banks instructed not to cash checks and other instruments (for example, drafts, money orders, etc.) drawn to the order of the company?			
11. Does company policy prohibit the cashing of any accommodation checks (for example, personal and payroll checks) out of collections?			
12. Are local bank accounts used for branch office collections subject to withdrawal only by the home office?			
13. Are banks instructed to deliver charged back deposit items (such as checks returned because of insufficient funds) directly to an employee independent of physical handling of cash receipts and posting of accounts receivable detail?			
14. Are bank chargebacks received directly from the bank and investigated by a person independent of:			
a. Physical handling of collections?			
b. Posting accounts receivable subsidiary detail?			
15. Are entries to the cash receipts journal compared with:			
a. Duplicate deposit slips authenticated by the bank?			
b. Deposits per the bank statements?			
c. Listings prepared (initial control) when mail is opened?			
16. Are the comparisons described in item 15 above made by a person(s) whose duties do not include cash receipts and accounts receivable functions?			

.510 Recording Collections

Objective

- All cash receipts are recorded at the correct amounts in the period in which received, and are properly classified and summarized.

Questions—Control Policies and Procedures

	Yes	No	N/A
1. Is information captured from remittances (by mail and over the counter) adequate for accurate posting of credits to individual accounts receivable subsidiary records or to classifications concerning such other sources as investment income, rents, sales of property or scrap, and proceeds of financing?			
(This information, for example, may be included on the listing prepared when the mail is opened, remittance advices which accompany customers' checks, detachable stubs from billings, photocopies of checks, copies of pre-numbered receipts issued for currency collections, etc.)			
2. Are details of daily collections balanced with the total credits to be distributed to appropriate general ledger accounts and to the total collections for the day before posting to the subsidiary records?			
3. Do postings of the general ledger control accounts and subsidiary records include the date on which the remittance was received?			
4. Are postings to the general ledger control accounts made by a person(s) independent of:			
a. Physical handling of collections?			

	Yes	No	N/A
b. Posting accounts receivable subsidiary detail?	___	___	___
5. Are details of collections posted to subsidiary accounts receivable records by a person(s) independent of:			
a. General ledger functions?	___	___	___
b. Physical handling of collections?	___	___	___
c. Receipt and investigation of bank chargebacks?	___	___	___

.520 Assignment of Disbursement Functions

Objective

- Functions are assigned so that no single individual is in a position to both perpetrate and conceal errors or irregularities in the normal course of his duties.

Questions—Control Policies and Procedures

	Yes	No	N/A
1. Is the cash disbursements function performed by persons who are independent of the following functions:			
a. Purchasing?	___	___	___
b. Receiving?	___	___	___
c. Invoice processing?	___	___	___
d. Payroll preparation and approval?	___	___	___
e. Shipping?	___	___	___
f. Accounts receivable?	___	___	___
g. Cash receipts?	___	___	___
h. General ledger?	___	___	___
2. Is there adequate separation of duties within the cash disbursement function among persons who perform the following:			
a. Control access to unissued checks?	___	___	___
b. Prepare checks?	___	___	___
c. Sign checks and inspect support?	___	___	___
d. Mail checks?	___	___	___
e. Maintain custody of petty cash?	___	___	___
f. Maintain the cash disbursement journal?	___	___	___
g. Reconcile the bank accounts?	___	___	___

.530 Processing Disbursements

Objectives

- Disbursements are made only for expenditures incurred in accordance with management's authorization.
- Adjustments to cash accounts are made only in accordance with management's authorization.
- Disbursements are recorded at correct amounts in the appropriate period and are properly classified in the accounts.
- Access to cash and cash disbursements records is restricted to minimize opportunities for irregular or erroneous disbursements.

Questions—Control Policies and Procedures

	Yes	No	N/A
1. Are all bank accounts authorized by the board of directors?	___	___	___
2. Are all check signers authorized by the board of directors?	___	___	___
3. Are banks promptly notified of any changes in authorized check signers?	___	___	___
4. Are banks instructed not to cash checks and other instruments (for example, drafts, money orders, etc.) drawn to the order of the company?	___	___	___
5. Are all bank accounts and cash funds subjected to general ledger control?	___	___	___
6. Are all disbursements and bank transfers based on vouchers and check requests which have been approved by responsible employees designated by management?	___	___	___
7. Are all disbursements except from petty cash made by check?	___	___	___

	Yes	No	N/A
8. Are properly approved supporting documents (processed invoices, purchase orders, receiving reports, etc.) presented with the checks and reviewed by the check signer(s) before signing the checks?			
9. Is a mechanical check protector used to inscribe amounts on checks as a precaution against alteration?			
10. Are supporting documents for checks properly cancelled to avoid duplicate payment?			
11. Are signed checks independently mailed directly after signing without being returned to persons involved in the invoice processing and check preparation functions?			
12. Is access to unissued checks limited to designated responsible employees who are independent of the check signing function, including operation of mechanical check signing machines?			
13. Are checks pre-numbered and all numbers accounted for?			
14. Are all voided checks retained and mutilated?			
15. Are all checks promptly recorded when issued and listed in detail (cash disbursements journal, check register, etc.)?			
16. Are details of individual disbursements balanced with the totals to be posted to appropriate general ledger account distributions and to total disbursements to be posted to the general ledger control accounts for cash?			
17. Is there a written policy which prohibits:			
a. Drawing checks payable to cash or bearer?			
b. Signing or countersigning of blank checks?			
18. If dual signatures are required:			
a. Are the two signers independent of one another?			
b. Does each signer determine that the disbursement is supported by approved documentation?			
19. If a check signing machine is used:			
a. Are checks approved before mechanical signing by designated responsible employees who are subject to the same segregation of duties as if they were authorized check signers?			
(Use of a check signing machine allows an entity to delegate authority for approving checks to a greater number of persons than those registered with the bank as authorized signers. However, approval procedures should be sufficient to assure the official whose name is on the signature plate that all mechanically signed checks would have met his approval if he had reviewed and manually signed them himself.)			
b. Are the keys, signature plate, and operation of the signing machine under control at all times of the official whose signature is on the plate?			
c. Are the employees who have custody of the keys, plate, and operate the check signing machine independent of voucher and check preparation functions and denied access to blank checks?			
d. Are the checks issued to the machine operator(s) counted in advance and reconciled with the totals of the counting device on the check signing machine by someone other than the machine operator?			
(Control may be strengthened by having a locked compartment on the machine which receives the signed checks and can be opened only by someone independent of the machine operator.)			
20. Are cash funds on an imprest basis and:			
a. Kept in a safe place?			
b. Reasonable in amount?			
c. Controlled by one custodian who is independent of invoice processing, check signing, general accounting, and cash receipts functions?			
d. Periodically counted by someone other than the custodian?			
21. Are all disbursements from cash funds:			
a. Supported by vouchers which are prepared in ink?			

	Yes	No	N/A
b. Approved in accordance with management's authorization?			
c. Cancelled to prevent reuse?			
d. Subject to a predetermined maximum dollar limit for any individual disbursement?			
22. Are reimbursements of cash funds:			
a. Subject to the same review and approval as processed invoices? (See AAM section 4400.230 on invoice processing)			
b. Remitted by checks drawn payable to the order of the custodian of the cash fund?			

.540 Bank Reconciliations

Objective

- Comparison of detail records, control accounts, and bank statements are made at reasonable intervals for detection and appropriate disposition of errors or irregularities.

Questions—Control Policies and Procedures

	Yes	No	N/A
1. Are the bank accounts reconciled monthly by an employee(s) who is independent of invoice processing, cash disbursements, cash receipts, petty cash, and general ledger functions?			
2. Are bank statements, related paid checks, debit and credit memos received directly from the bank by the employee(s) performing the reconciliations?			
3. Does the bank reconciliation procedure include:			
a. Reconciliation of the balance per bank to balance per the general ledger control account and subsidiary detail records?			
b. Comparison in detail of deposits per the bank statement with deposits per cash receipts detail records?			
c. Comparisons in detail of disbursements per bank with the cash disbursements journal (check register) as to date drawn, payee, and amount?			
d. Comparison of payees with endorsements?			
e. Follow up of reconciling items and initiation of entries to record such transactions as checks returned for insufficient funds, and bank charges?			
4. Are old outstanding checks investigated and subjected to proper disposition (in compliance with applicable escheat laws if present)?			

[The next page is 4501.]

AAM Section 4500
Flowcharts

.01 A flowchart is a diagram which uses symbols to portray the flow of transactions and the various steps applied in that process.

.02 Use of flowcharts is widespread among persons involved in computerized information processing. Some auditors also use flowcharts as their preferred method of documenting their understandings of their clients' internal control structure. Some firms, as an internal policy, urge their staff auditors to use flowcharting. Other firms require use of flowcharting on audits of clients over a given level of size or complexity.

.03 The decision to use flowcharts rests with the individual firm or auditor. Proponents of flowcharting believe the auditor can more easily read and analyze a flowchart than a narrative description of a structure, especially when reviewing understandings which are developed by assistants. They also believe the discipline needed to prepare flowcharts encourages staff to obtain a clearer, more accurate understanding of the structure being documented, particularly the control points in the structure. Those with reservations about flowcharting are concerned that the potential benefits of flowcharting are not enough to justify the time and effort needed to prepare them. They also are concerned that staff may get lost in excessive detail or stray into extraneous areas. A decision to use flowcharts, therefore, implies a concurrent decision to develop adequate instructional material.

Types of Flowcharts

.04 Some users of flowcharts classify them into the following three types:

- Systems flowchart—provides a broad overview of a system.
- Program flowchart—concerned with the minute steps of a system, generally a computer program. Some users also describe computer program flowcharts as block diagrams.
- Internal control structure flowchart—portrays the interaction of departments and/or individuals involved in the plan of organization and the procedures and records concerned with the safeguarding of assets and the reliability of financial records.

Some data processing people who tend to confront complex situations develop sets of charts in several layers with each layer oriented towards a different level of users; this is termed a hierarchical approach.

Degree of Detail

.05 The question of how much detail an auditor should include in a flowchart is a difficult one. And the answer is elusive; it varies with the professional judgment of the auditor who has final responsibility for the engagement. A related difficult matter is how to help assistants avoid the pitfalls of including excess and/or extraneous detail in their flowcharts and the accompanying run-up of time. In deciding on an appropriate policy, the auditor should recognize that his working papers, taken as a whole, should be adequate to document his understanding of the client's internal control structure and help support his assessments of control risk.

Flowcharting Illustration—Small Business

.06 Use of flowcharts need not be limited to recording an understanding of complex information processing systems. An illustration is included below to show how an auditor might use flowcharts to record an understanding of purchases, receipt of stock, and cash disbursements for purchases for Kilroy Wholesale Grocery. John Kilroy owns and operates the business with two employees. One employee serves as both the stock clerk and truck driver. The other employee is the bookkeeper.

.07 A symbol legend is also included to explain the five different symbols used in the illustrative flowcharts. In practice, an auditor would probably use a standard set of flowchart symbols which would eliminate the need for preparing flowchart symbol legends for each set of working papers. The symbols used in the illustrative flowcharts are from the set of standard flowcharting symbols developed by the American National Standards Institute, Inc. (ANSI) which is sponsored by the Business Equipment Manufacturers Association. [1] Some accounting firms have developed or adopted other sets of symbols to meet their individual needs.

.08 The following illustrative transaction processing flowcharts of Kilroy Wholesale Grocery are presented as:

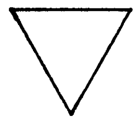
- Purchases and Receipts of Stock (paragraphs .11—.12)
- Cash Disbursements for Purchases (paragraphs .13—.14)

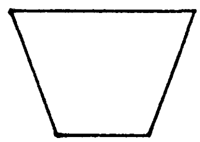
.09 There are also various approaches to the layout of flowcharts. For example, the illustrations present the functions of more than one person (or department) on each sheet. An alternate approach would be to limit a page or set of pages to the functions of a single department or individual. In addition, the illustrative flowcharts present vertical flow lines that start at the top of the page. An alternate approach would be to present horizontal flow lines that start at the left side of the page. These alternate approaches depend on the preferences of the individual firm or the auditor who has final responsibility for the engagement.

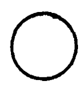
[1] ANSI, American National Standard Flow Chart Symbols and Their Usage in Information Processing. (1430 Broadway, New York, N.Y. 10018) 1971.

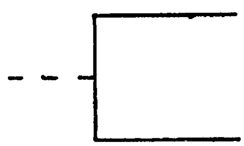
.10 Kilroy Wholesale Grocery
Symbol Legend - Transaction Processing
Flowcharts


= Document

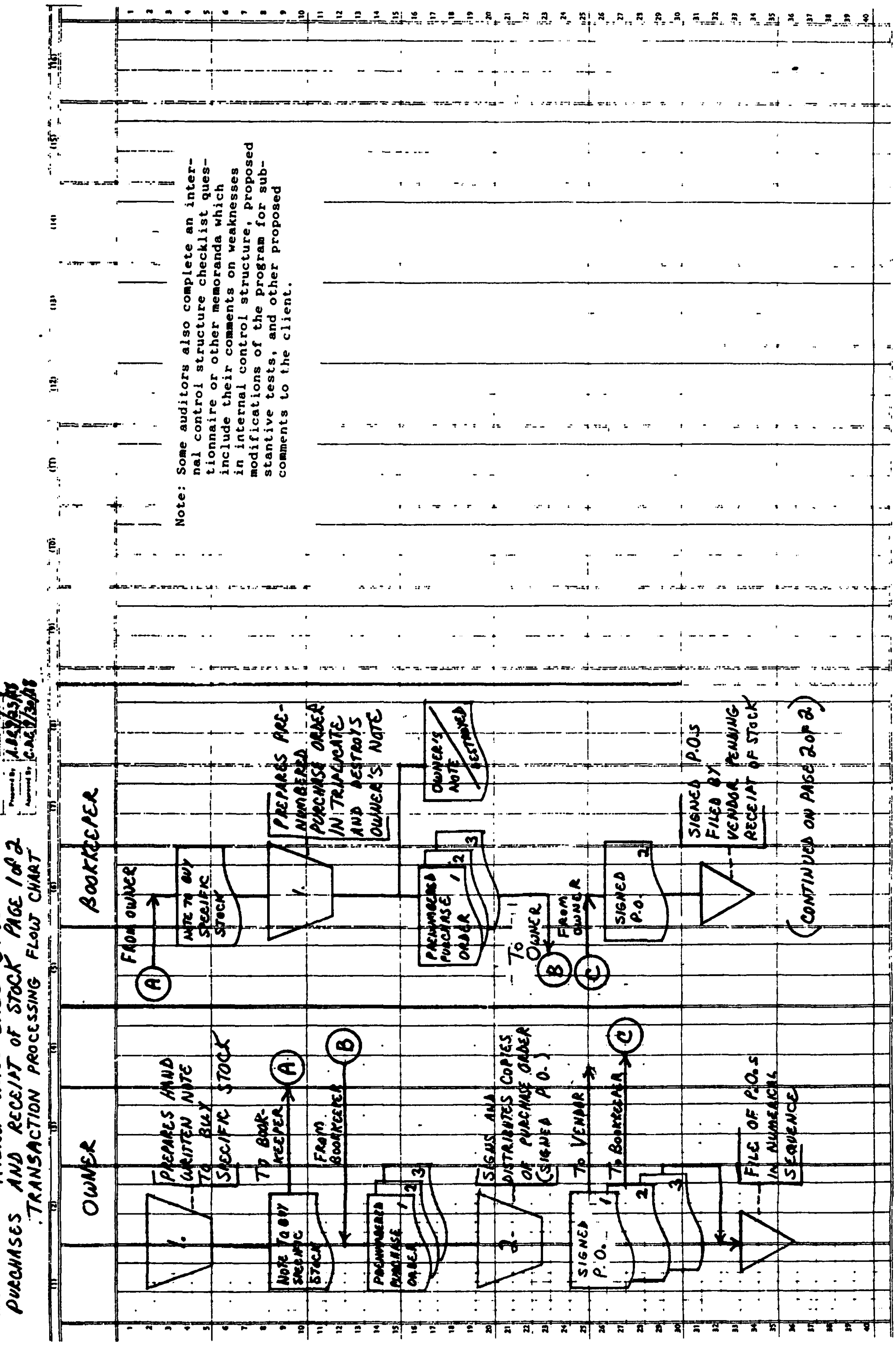

= File


= Manual operations. This symbol represents a process or work step performed by a person.

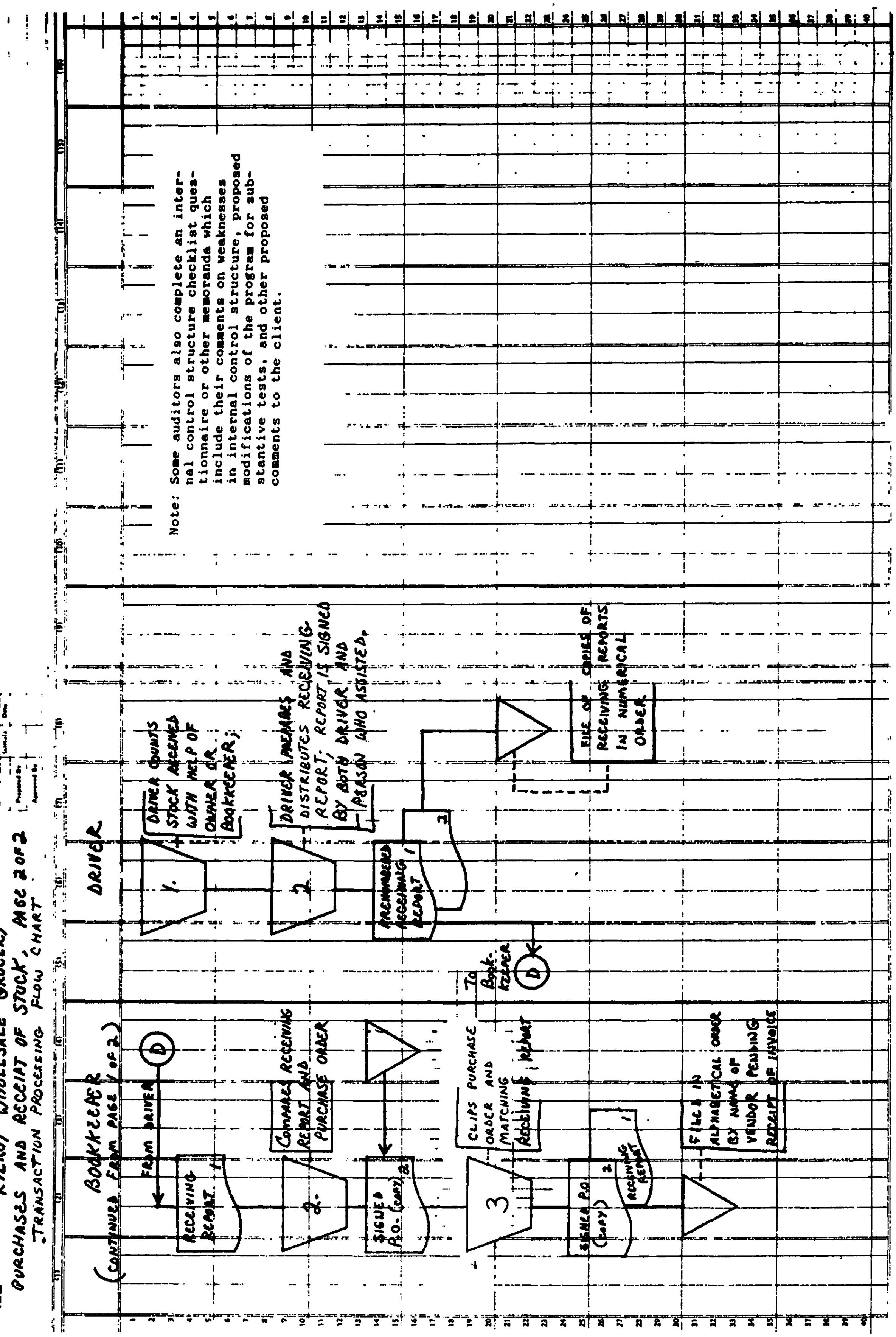

= Connector symbol. Used as a cross reference within a page or between pages.


= Comment or annotations symbol. This symbol is used to present comment or additional explanation which would not be able to fit within other symbols.

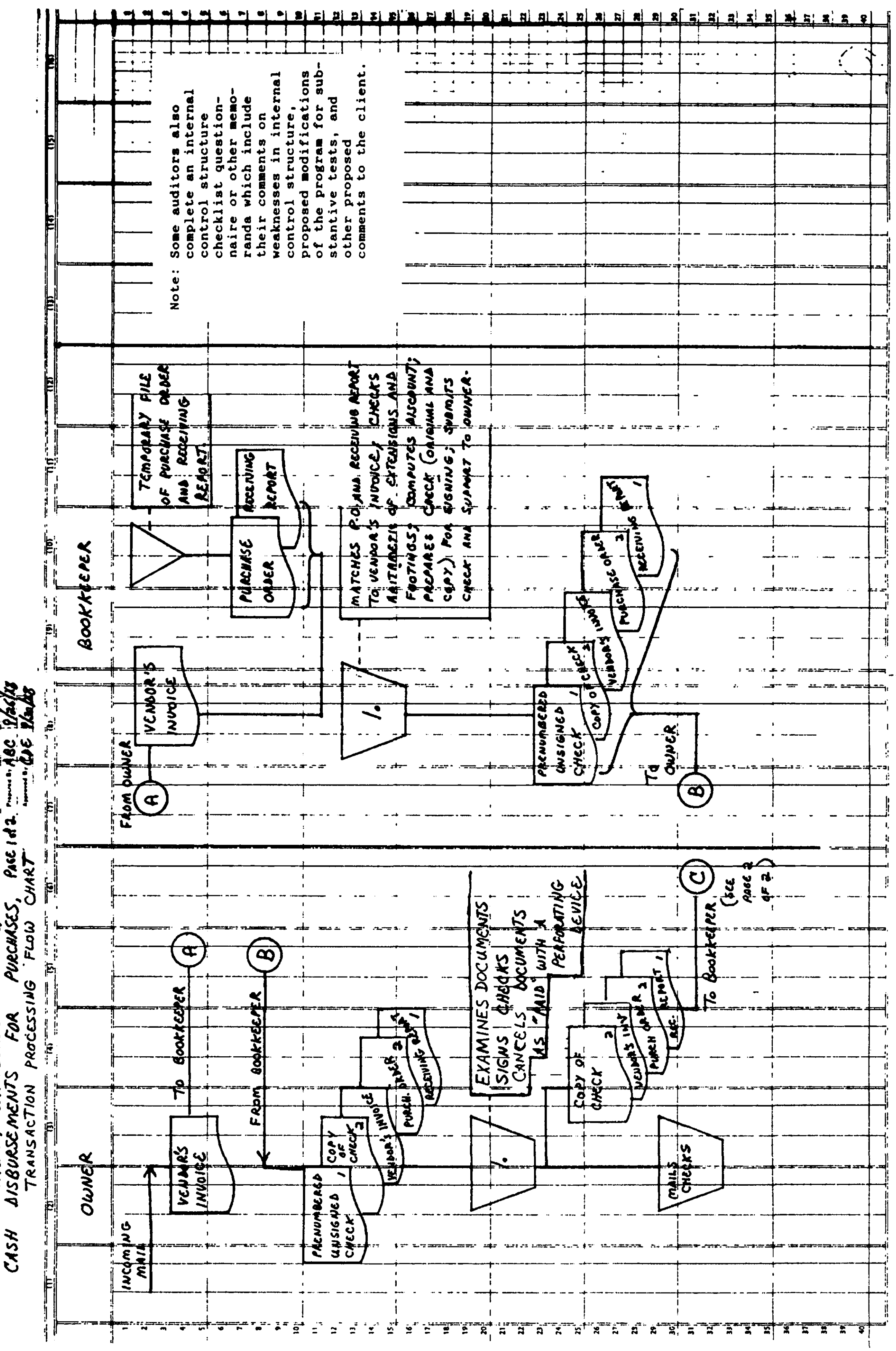
.11


KILROY WHOLESALE GROCERY
PURCHASES AND RECEIPT OF STOCK PAGE 1 of 2
TRANSACTION PROCESSING FLOW CHART
OWNER
BOOKKEEPER
PREPARES HAND WRITTEN NOTE TO BUY SPECIFIC STOCK
TO BOOKKEEPER
NOTE TO BUY SPECIFIC STOCK
FROM BOOKKEEPER
PRENUMBERED PURCHASE ORDER
SIGNS AND DISTRIBUTES COPIES OF PURCHASE ORDER (SIGNED P.O.)
SIGNED P.O.
TO VENDOR
TO BOOKKEEPER
FILE OF P.O.s IN NUMERICAL SEQUENCE
FROM OWNER
PREPARES PRE-NUMBERED PURCHASE ORDER IN TRIPLICATE AND DESTROYS OWNER'S NOTE
OWNER'S NOTE DESTROYED
TO OWNER
FROM OWNER
SIGNED P.O.s FILED BY VENDOR PENDING RECEIPT OF STOCK
(CONTINUED ON PAGE 2 of 2)
Note: Some auditors also complete an internal control structure checklist questionnaire or other memoranda which include their comments on weaknesses in internal control structure, proposed modifications of the program for substantive tests, and other proposed comments to the client.

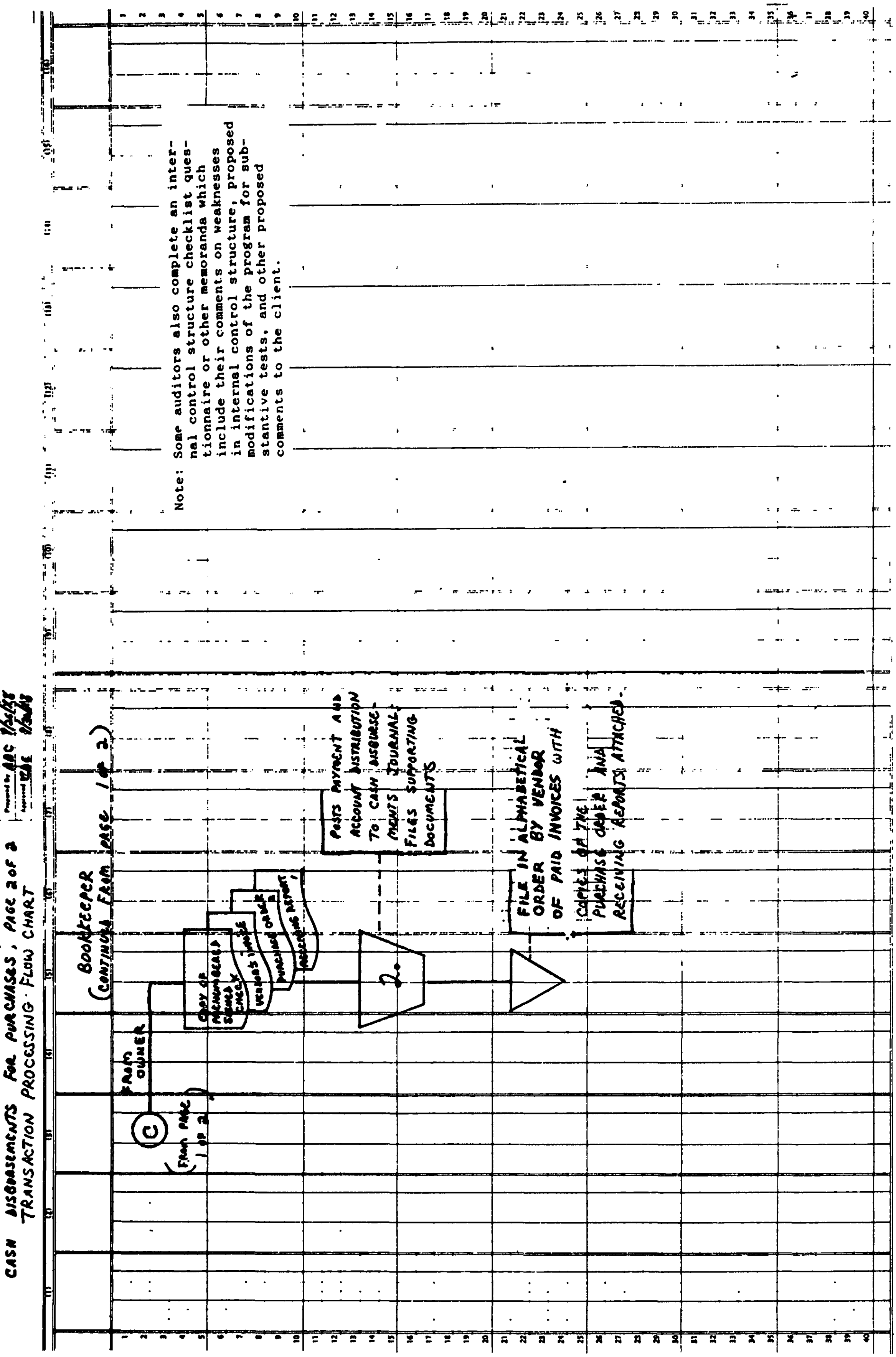
.12


KILROY WHOLESALE GROCERY
PURCHASES AND RECEIPT OF STOCK, PAGE 2 OF 2
TRANSACTION PROCESSING FLOW CHART
BOOKKEEPER
(CONTINUED FROM PAGE 1 OF 2)
FROM DRIVER
D
RECEIVING REPORT 1
COMPARES RECEIVING REPORT AND PURCHASE ORDER
2
SIGNED P.O. (COPY) 2
CLIPS PURCHASE ORDER AND MATCHING RECEIVING REPORT
3
SIGNED P.O. (COPY) 2
RECEIVING REPORT 1
FILED IN ALPHABETICAL ORDER BY NAME OF VENDOR PENDING RECEIPT OF INVOICE
To BOOKKEEPER
D
DRIVER
1
DRIVER COUNTS STOCK RECEIVED WITH HELP OF OWNER OR BOOKKEEPER;
2
DRIVER PREPARES AND DISTRIBUTES RECEIVING REPORT; REPORT IS SIGNED BY BOTH DRIVER AND PERSON WHO ASSISTED.
PRENUMBERED RECEIVING REPORT 1
2
FILE OF COPIES OF RECEIVING REPORTS IN NUMERICAL ORDER
Note: Some auditors also complete an internal control structure checklist questionnaire or other memoranda which include their comments on weaknesses in internal control structure, proposed modifications of the program for substantive tests, and other proposed comments to the client.

.13


KILROY WHOLESALE GROCERY
CASH DISBURSEMENTS FOR PURCHASES, PAGE 1 of 2
TRANSACTION PROCESSING FLOW CHART
OWNER
BOOKKEEPER
INCOMING MAIL
VENDOR'S INVOICE
TO BOOKKEEPER
A
FROM BOOKKEEPER
B
PRENUMBERED UNSIGNED CHECK 1
COPY OF CHECK 2
VENDOR'S INVOICE
PURCH. ORDER 2
RECEIVING REPT 1
EXAMINES DOCUMENTS SIGNS CHECKS CANCELS DOCUMENTS AS "PAID" WITH A PERFORATING DEVICE
COPY OF CHECK 2
VENDOR'S INV
PURCH ORDER 2
REC. REPORT 1
MAILS CHECKS
TO BOOKKEEPER
C
(SEE PAGE 2 OF 2)
FROM OWNER
A
VENDOR'S INVOICE
TEMPORARY FILE OF PURCHASE ORDER AND RECEIVING REPORT
PURCHASE ORDER
RECEIVING REPORT
MATCHES P.O. AND RECEIVING REPORT TO VENDOR'S INVOICE; CHECKS ARITHMETIC OF EXTENSIONS AND FOOTINGS; COMPUTES DISCOUNT; PREPARES CHECK (ORIGINAL AND COPY) FOR SIGNING; SUBMITS CHECK AND SUPPORT TO OWNER.
PRENUMBERED UNSIGNED CHECK 1
COPY OF CHECK 2
VENDOR'S INVOICE
PURCHASE ORDER 2
RECEIVING REPT 1
TO OWNER
B
Note: Some auditors also complete an internal control structure checklist questionnaire or other memoranda which include their comments on weaknesses in internal control structure, proposed modifications of the program for substantive tests, and other proposed comments to the client.

.14



[The next page is 4601.]

AAM Section 4600

Illustrative Internal Control Structure Questions—State and Local Governmental Units

.010 The following is a list of illustrative internal control structure questions an auditor might raise concerning a state or local governmental unit. The extent of internal control structure policies and procedures that an organization should establish is a judgment that must be made by the management of the entity. The judgment is affected by circumstances, such as the size of the organization and the number of personnel available, and by conclusions about the relationship of costs and benefits. These illustrative questions are numbered merely for organization purposes. The numbers are in no way intended to infer completeness or a preferred sequence. A firm that believes the questionnaire approach is appropriate for its practice should develop its own internal control structure questionnaires based on its own needs and preferences. In any event, users of checklists and questionnaires should recognize that important matters in a particular set of circumstances may not be covered in a standard checklist.

I. Control Environment *

.020 The control environment represents the collective effect of various factors on establishing, enhancing, or mitigating the effectiveness of specific policies and procedures. Such factors include the following:

- Management's philosophy and operating style
- The entity's organizational structure
- Personnel policies and practices
- Methods of assigning authority and responsibility
- Management's control methods for monitoring and following-up on performance, including internal auditing and budgeting
- Various external influences that affect an entity's operations and practices

.030 The control environment reflects the overall attitude, awareness, and actions of the legislative, management, staff, and others concerning the importance of the control and its emphasis in the entity.

.040 The following questions are to assist the auditor in obtaining an understanding of the control environment and assessing the control risk.

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Complete-ness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
.050 A. Management's Philosophy and Operating Style							
1. Does management often enter into particularly high-risk ventures, or is extremely conservative in accepting risks?	—	—	—		—		
2. Does management conduct business on a high ethical plane and insist that others do so, or pay little attention to ethical issues?		—			—		
3. Does management have to meet rigid targets to receive a portion of their compensation (e.g., bonus), particularly when such targets are considered unreasonably difficult?		—		—	—		
4. What is management's attitude and actions toward financial reporting, including disputes over application of accounting treatment (e.g., selection of conservative versus liberal accounting policies; whether accounting principles have been misapplied, important financial information not disclosed, or records manipulated or falsified)?					—		
5. Is management conscientious and applies integrity with the judgmental aspects of reporting, when developing estimates?				—	—		
6. Is there frequent interacting between senior management and operating management, particularly for geographically removed units?	—	—					
7. What is management's attitude toward the data processing and accounting functions, and their concerns about the reliability of financial reporting and safeguarding assets?	—				—		
8. Has management communicated a commitment to a strong internal control structure to employees during the past year?	—	—			—		
9. Does management periodically review the internal control structure to ensure that it is being enforced?	—	—					
10. What is management's attitude towards overriding or bypassing established controls?	—	—					
11. Has management conveyed the message that ethics cannot be compromised and have employees received and understood that message?	—						
12. Does the "tone at the top" include explicit moral guidance about what is right and what is wrong, and is it established and communicated throughout the organization?	—				—		
.060 B. Organizational Structure							

* The control environment questions in AAM section 4600.020—.100 specifically apply to governmental entities and are not intended to be all inclusive. The auditor should also consider the illustrative control environment inquiries in AAM section 4400.050—.110, which may apply to governmental entities.

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Complete-ness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
1. Is the organizational structure so simple that it cannot adequately monitor the organization's activities, or so complex that it inhibits the necessary flow of information?	—	—					
2. Does management fully understand their control responsibilities and possess the requisite experience and levels of knowledge commensurate with their positions?	—						
3. Is there an adequate definition of key managers' responsibilities and an appropriate understanding of those responsibilities?	—	—					
4. Do key managers possess the appropriate knowledge and experience in light of their responsibilities?	—	—					
5. Is the entity's organizational structure appropriate so as to provide the necessary information flow to manage its activities?	—	—					
6. Are the reporting relationships appropriate?	—	—					
7. To what extent are organizational modifications made in light of changing conditions?	—	—					
8. Are there sufficient quantities of employees, particularly in management and supervisory capacities?	—	—					
9. Is the organization chart current?	—	—					
10. Is the organization properly synchronized for the program/budget structure?	—	—			—		
11. Are goals and objectives for the organization current and in writing?	—	—					
12. Are functional statements current and in writing and consistent with organization chart?	—	—					
.070 C. Personnel Policies and Procedures							
1. Do personnel practices include:							
a. A code of conduct?	—						
b. Provisions for conflict of interest disclosure?	—						
2. Are there accurate and up-to-date performance standards?	—	—					
3. Are the performance standards consistent with the operating plan?	—	—					
4. Is there periodic performance review (appraisal) of all employees?	—						
5. Are there sufficient training opportunities to ensure all employees are competent to perform work assigned?	—	—					
6. To what extent are policies and procedures for hiring, training, promoting, and compensating employees in place?	—	—					
7. To what extent are employees made aware of their responsibilities and expectations of them?	—	—					
8. Is there appropriate remedial action taken in response to departures from approved policies and procedures and violations of the code of conduct?	—						
9. Are there adequate employee candidate background checks, particularly with regard to prior actions or activities considered to be unacceptable by the entity?	—						
10. Are there adequate employee retention and promotion criteria, and related information gathering techniques, related to compliance with the code of conduct or other behavioral guidelines?	—						
11. Do management performance standards include provisions for maintaining adequate internal controls?	—						
12. Are employees adequately supervised?	—	—					
13. Are staffing levels adequate?	—	—					
14. Is turnover low?	—	—					
15. Do employees have copies of their current position description?	—	—					

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Complete-ness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
16. Is orientation training conducted for new employees?	—						
17. Are employees aware of their rights to communicate with any official of rank higher than their immediate supervisor?	—	—			—		
.080 D. Authority and Responsibility							
1. Are delegations of authority and responsibility current and in writing?	—						
2. Do the delegations of authority and responsibility reflect the segregation of duties concept?	—	—					
3. Are the job descriptions descriptive of the jobs actually performed?	—	—					
4. Do the delegations of authority and responsibility grant officials necessary authority to carry out functions for which they are responsible?	—	—					
5. Are employees held accountable for performance and results achieved?	—	—					
6. Do managers routinely follow-up on delegations of authority and responsibility to subordinates?	—	—					
.090 E. Management Control Methods							
1. Is there a long-range planning process?	—	—					
2. Is the budgeting system integrated with the planning process?	—	—			—		
3. Are plans and budgets effectively communicated throughout the organization?	—	—			—		
4. Are responsibilities for budget preparation, adoption, execution, and reporting segregated?	—	—			—		
5. Is a budget calendar used for the orderly submission and approval of the budget?	—	—					
6. Are budgets prepared for all significant activities regardless of whether mandated by law?	—	—					
7. Is the budget prepared in sufficient detail providing a meaningful tool with which to monitor subsequent performance?	—	—			—		
8. Is citizen input obtained through budget hearings?	—	—	—				
9. Has the budget been submitted to the legislative body for approval and is there clear communication to operation departments or agencies of the effects of legislatively mandated budget modifications, either increases or decreases?	—						
10. Are interfund and interdepartmental transfers included in the budget?	—	—			—		
11. Is the type of budgeting performed compatible with the accounting system?	—	—			—		
12. Are budgets published if required by law?	—				—		
13. Are estimated revenues and appropriations recorded in the accounting records for later comparison to actual amounts realized or incurred?	—	—		—	—		
14. Have procedures been adopted and communicated establishing authority and responsibility for transfers between budget categories?	—	—	—		—		
15. Is the flow of expenditures or commitments controlled through the use of an allotment system?	—	—	—				
16. Does the accounting department submit approval as to availability of funds before the issuance of a purchase order or expenditure commitment?	—	—	—				

	Existence or Occurrence	Complete-ness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Audit Tests of Controls: Program or W/P Reference	Substantive Tests: Program Reference
	ASSERTIONS						
17. Are requests for supplemental appropriations or budget changes processed and approved in the same manner as the original budget is processed and approved?	—	—	—		—		
18. If liabilities and expenditures are recorded on an encumbrance or obligation basis, are there controls to ensure knowledge of outstanding commitments?	—	—	—		—		
19. Are actual expenditures compared to budget with reasonable (monthly) frequency and on a timely basis?		—		—	—		
20. Are reports discussed with departmental personnel and are there explanations for significant variations from budget?		—		—	—		
21. Are executive and legislative branches notified of expenditures in excess of appropriations or budgets?	—		—		—		
22. Are actual results of operations against budget published if required by law?	—	—		—	—		
23. Are the adequacy and effectiveness of the internal control structure policies and procedures relevant to the entity's transaction classes and are account balances periodically evaluated?	—	—			—		
24. Are measures implemented to correct weaknesses?	—						
25. Are there clearly established levels of operational and financial accountability?	—	—					
26. Are program evaluations/management reviews routinely performed?	—	—			—		
27. Are audits routinely performed?	—	—			—		
28. Are procedures in place and adhered to which require prompt implementation of resolved audit findings or program/management review results?	—	—			—		
29. Are policies and procedures current and in writing?	—						
30. Are policies and procedures consistent with statutory authorities?	—	—	—				
31. Are all policies and procedures clearly stated and systematically communicated (manuals, handbooks, etc.)?	—	—					
32. Do the policies and procedures support the internal control structure?	—	—					
33. Are there channels of communication for people to report suspected improprieties?							
a. Ability to contact someone other than a direct supervisor?	—	—					
b. Anonymity permitted?	—						
34. Is feedback provided to people who report suspected improprieties and do they have immunity from reprisals?	—	—					
a. Is management receptive to such reports?	—						
35. Are outside parties made aware for the entity's ethical standards?	—						
36. Is there timely and appropriate follow-up action by management resulting from external party communications, such as:							
a. Customer complaints?	—	—					
b. Notification of errors in billings?	—	—		—	—		
c. Notification of inappropriate behavior by an employee?	—						
37. Are there mechanisms to identify and react to changes that can have a more dramatic and pervasive effect on the entity, and may demand the attention of senior management? Some examples include:							
a. New laws or regulations that affect the entity or its activities,	—	—					

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Completeness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
b. New or redesigned information systems,	—	—			—		
c. New technology incorporated into the information systems.	—	—			—		
.100 F. External Influences							
1. Is the organization subject to external forces or pressures which make it vulnerable to errors?	—	—			—		
2. Does the public perceive this organization to be adequately controlled?	—				—		
Phase 1: Preliminary Risk Assessment	L M H	L M H	L M H	L M H	L M H		
Phase 2: Final Risk Assessment—Based on audit tests of controls	L M H	L M H	L M H	L M H	L M H		

II. Accounting System

.110 The accounting system consists of 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. The auditor should obtain knowledge of the accounting system to understand:

- The classes of transactions in the entity's operations that are significant to the financial statements.
- How those transactions are initiated.
- The accounting records, supporting documents, computer media, and specific accounts in the financial statements involved in the processing and reporting of transactions.
- The accounting processing involved from the initiation of a transaction to its inclusion in the financial statements, including how the computer is used to process data.
- The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures.

.120 The following questions are to assist the auditors in obtaining an understanding of the accounting system and assessing the control risks.

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Complete-ness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
.130 A. General							
1. Does the entity have adequate written statements and explanations of its accounting policies and procedures? (Written accounting policies and procedures may include such matters as: (i) Chart of accounts accompanied by explanations of the items to be included in the various accounts. (ii) Identification and description of the principal accounting records, recurring standard entries, and requirements for supporting documentation. For example, this may include information about the general ledger, source journals, subsidiary ledgers, and detail records for each significant class of transactions. (iii) Expression of the assignment of responsibilities and delegation of authority including identification of the individuals or positions that have authority to approve various types of recurring and non-recurring entries. (iv) Explanations of documentation and approval requirements for various types of recurring and non-recurring transactions and journal entries. Documentation requirements, for example, would include the basis and supporting computations required for adjustments and write-offs. (v) Instructions for determining an adequate cutoff and closing of accounts for each reporting period.)	—	—					
2. Are accounting policy and procedure manuals updated as necessary?	—	—					
3. Are manuals distributed to appropriate personnel?		—					
4. Do procedures exist to ensure that only authorized persons can alter or establish a new accounting principle, policy, or procedure to be used by the entity?	—	—	—	—	—		
5. Does the principal accounting officer of the entity have adequate authority over accounting employees and principal accounting records at all locations?	—	—					
6. Are the principal accounting, treasury, and custody functions segregated?	—	—					
7. Are the responsibilities for maintaining the general ledger segregated from those for maintaining subsidiary ledgers?	—	—					
8. Are the responsibilities for maintaining the general ledger and custody of assets segregated?		—					

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Complete-ness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
9. Is access to the general ledger and related records restricted to those who are assigned general ledger responsibilities?	—						
10. Are there adequate facilities for custody of the general ledger and related records? (Examples of such facilities include fire-resistant locked cabinets, vaults, physical barriers, separate rooms, limited access to work areas, alarms, and other detection devices.)	—						
11. Is appropriate insurance coverage maintained in amounts required by statutes or entity policy? (Such insurance may include loss of records coverage and fidelity bonding of employees in positions of trust.)	—			—			
12. Are the preparation and approval functions for journal entries segregated?	—	—		—			
13. Are all journal entries reviewed and approved by designated individuals at appropriate levels in the entity? (The levels at which journal entries are reviewed and approved will usually vary depending on whether the entries are recurring, or non-recurring, routine or unusual, accumulations of routine transactions, or adjustments of balances requiring estimates and judgments.)	—	—		—			
14. Are all journal entries adequately explained and supported? (Explanation and support for an entry should be sufficient to enable the person responsible for its review and approval to reasonably perform this function.)	—	—					
15. Do all journal entries include approval in accordance with management's general or specific authorization?	—	—					
16. Are all journal entries subject to controls over completeness of processing? (Examples of controls over completeness of processing include pre-numbering of journal vouchers and accounting for all numbers used, accumulation of control totals of dollar amounts debited and credited, and standard identification numbers for recurring entries.)	—	—					
17. Do all journal entries include adequate identification of the accounts in which they are to be recorded?	—	—		—	—		

.140 B. Electronic Data Processing

Segregation of Duties

	Existence or Occurrence	Complete-ness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
1. Is the EDP department independent from the accounting and operating departments for which it processes data?	—						
2. Does appropriate segregation of duties exist within the data processing function for (a) systems development (design and programming), (b) technical support (maintenance of systems software), and (c) operations?	—	—					
3. In smaller and minicomputer installations with limited opportunities for segregation of duties, do procedures exist for user departments to— ● Utilize batch or other input controls? ● Control master file changes? ● Balance master files between processing cycles?	—	—		—			
4. Do the personnel policies of the EDP function include such procedures as reference checks, security statements, rotation of duties, and terminated employee security measures that enhance segregation of duties and otherwise improve controls?	—						

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
Procedural Controls							
User Controls							
5. Do controls exist over preparation and approval of input transactions outside the EDP department and is the department prohibited from initiating transactions?	—	—					
6. Does the user exercise control procedures over input to ensure that all approved input is processed correctly through the system and only once?	—	—		—			
7. Do controls exist over entry of data in on-line systems to restrict access to terminals and data entry to authorized employees?	—	—					
8. Do on-line systems controls exist that prevent documents from being keyed into the system more than once and that permit tracing from computer output to data source and vice versa?	—	—					
9. Do controls exist over changes to master files, such as requiring preparation of specific forms indicating data to be changed, approval by a supervisor in the user department, and verifying against a printout of changes?	—	—					
10. Do user controls exist over rejected transactions through the use of a computerized suspense file of rejected transactions or an auxiliary manual system?	—	—					
11. Does user department management reconcile output totals to input totals for all data submitted, reconcile the overall file balances, and review outputs for reasonableness?	—	—		—			
Application Controls							
12. Do procedures exist within the data processing control function that provide that data is properly controlled between the user and the EDP department?	—	—					
13. Do controls exist over data entry, for example, that include adequate supervision, up-to-date instructions, key verification of important fields, and self-checking digits?	—	—					
14. Do program controls exist over entry of data into on-line systems?	—	—					
15. Is input data edited and validated?	—	—					
16. Do data processing controls exist over rejected transactions?	—	—					
17. Do controls exist for balancing transactions and master files?	—	—		—			
18. Do procedures exist within the data processing control function concerning review and distribution of output?	—	—					
General Controls							
19. Do controls exist over changes to system software?	—	—					
20. Do controls exist over use and retention of tape and disk files, including provisions for retention of adequate records to provide backup capabilities?	—	—					
21. Do controls exist that limit access to data processing equipment, tapes, disks, system documentation, and application program documentation to authorized employees?	—	—					
22. Is a job accounting system (or console logs) used to ensure that scheduled programs are processed and proper procedures followed and that supervisory personnel know that only required programs have been processed?	—	—					
23. Are EDP department employees supervised for all shifts?	—	—					
24. Are procedures to be followed by computer operators documented?	—	—					

	ASSERTIONS: Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Audit Tests of Controls: Program or W/P Reference	Substantive Tests: Program Reference
25. Is the data processing system documented such that the organization could continue to operate if important data processing employees leave?	—						
26. Do procedures exist to protect against a loss of important files, programs, or equipment?	—	—					
27. Are equipment, programs, and data files covered by insurance?	—						
28. Are there user-approved written specifications for new systems and modifications to existing application systems?	—	—					
29. Are there written procedures to test and implement new systems and modifications to existing application systems?	—	—					
.150 C. Financial Reporting							
Segregation of Duties							
1. Is the final review and approval of financial reports segregated from the responsibility for preparation of the reports?	—	—					
Procedural Controls							
General Ledger							
2. Is there a formal plan of organization for the unit of government under which reporting responsibilities are clearly defined and reasonably aligned?	—	—					
3. Is the principal accounting officer over accounting records and accounting employees supervised at all locations?	—	—					
4. Is there general ledger control over all assets and transactions of all departments of the organization?	—	—		—			
Closing							
5. Are procedures and policies for closing the accounts for a reporting period sufficient to ensure that accounts are closed, adjusted, and reviewed on a timely basis?	—	—		—			
6. Do procedures exist to ensure that all accounting systems have included all transactions applicable to the reporting period?		—					
7. Are valuation reserves or other account balances based on estimates reviewed and approved?	—			—			
8. Are all journal entries reviewed, approved, and supported by adequate descriptions or documentation?	—	—					
9. Do controls exist that ensure that only authorized individuals can initiate entries?	—						
Combining							
10. Do procedures exist to ensure the orderly and effective accumulation of financial data?	—	—			—		
11. Do procedures exist for the orderly processing of financial data received from departments and other accounting units?	—	—			—		
12. Do procedures exist to permit the recording and review of special entries generated in the combining process?	—	—			—		
Preparation, Review and Approval							
13. Do procedures exist to ensure that financial reports are supported by either underlying account records or other documentation?	—						
14. Do procedures exist providing reasonable assurances that all data required to be included in legal as well as public reports are properly disclosed?		—			—		
15. Do procedures exist to ensure that financial reports are prepared on a consistent basis?	—	—			—		

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Complete-ness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
16. Are financial reports reviewed and approved at appropriate levels of management and, if appropriate, by the legislature before public release?	—				—		
17. Are there procedures to ensure that all requirements for filing of financial reports are met (for example, senior levels of government, bondholders, and the public)?	—	—		—			
.160 D. Identified Significant Account Balances and Transaction Classes							
1. Cash?	—						
2. Investments?	—						
3. Revenues and Receivables?	—						
4. Capital Assets?	—						
5. Procurement and Payables?	—						
6. Employee Compensation?	—						
Phase 1: Preliminary Risk Assessment	L M H	L M H	L M H	L M H	L M H		
Phase 2: Final Risk Assessment—Based on audit tests of controls	L M H	L M H	L M H	L M H	L M H		

III. Control Procedures

.170 Control procedures are those policies and procedures in addition to the control environment and accounting system that management has established to provide reasonable assurance that specific entity objectives will be achieved. Control procedures have various objectives and are applied at various organizational and data processing levels. They may also be integrated into specific components of the control environment and the accounting system. Generally, they may be categorized as procedures that pertain to—

- Proper authorization of transactions and activities.
- Segregation of duties that 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 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 the proper recording of transactions and events, such as monitoring the use of pre-numbered 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, comparison 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.

.180 Questions for the following functional areas have been included to assist the auditor in obtaining an understanding of the control procedures and assessing the control risk:

- Cash
- Investments
- Revenues and Receivables
- Capital Assets
- Procurement and Payables
- Employee Compensation

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Completeness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
.190 A. Cash							
Segregation of Duties							
1. Are responsibilities for collection and deposit preparation functions segregated from those for recording cash receipts and general ledger entries?		—					
2. Are responsibilities for cash receipts functions segregated from those for cash disbursements?		—					
3. Are responsibilities for disbursement preparation and disbursement approval functions segregated from those for recording or entering cash disbursements information on the general ledger?	—	—		—			
4. Are responsibilities for the disbursement approval function segregated from those for the disbursement, voucher preparation, and purchasing functions?	—			—			
5. Are responsibilities for entries in the cash receipt and disbursement records segregated from those for general ledger entries?	—	—					
6. Are responsibilities for preparing and approving bank account reconciliations segregated from those for other cash receipt or disbursement functions?	—	—			—		
7. If EDP is used, is the principle of segregation of duties within processing activities maintained?	—	—					

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Completeness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
Procedural Controls							
Collections							
8. Are all receipts deposited on a timely basis (preferably daily)?		—					
9. Do controls exist over the collection, timely deposit, and recording of collections in the accounting records in each collection location?		—					
10. Is the general accounting department notified on a timely basis of cash receipts from separate collection locations?		—					
11. Are daily reported receipts compared on a test basis to bank statements to verify timeliness of deposits?	—						
12. Is a restrictive endorsement placed on each incoming check upon receipt?		—					
13. Are "not sufficient funds" checks delivered to someone independent of processing and recording of cash receipts?		—					
14. Do procedures exist for follow-up of "not sufficient funds" checks?		—					
15. Do controls exist to ensure that checks are returned promptly for deposit if checks received are forwarded to be used as posting media to taxpayers' or customers' accounts?		—					
16. Are receipts controlled by cash register, pre-numbered receipts, or other equivalent means if payments are made in person (over the counter)?		—					
17. Are receipts accounted for and balanced to collections on a daily basis?	—	—					
18. Do facilities exist for protecting undeposited cash receipts?	—	—					
Disbursements							
19. Does control exist over warrant or check-signing machines as to signature plates and usage?	—	—					
20. Are procedures provided for immediate notification to banks when warrant or check signers leave the unit or are otherwise no longer authorized to sign?	—	—					
21. Are invoices and supporting documents furnished to the signer prior to signing the warrant or check?	—	—		—			
22. Are reasonable limits set on amounts that can be paid by facsimile signatures?	—						
23. Are two signatures required on warrants or checks over a stated amount?	—						
24. Are signature plates maintained in the custody of the person whose facsimile signature is on the plate when not in use?	—						
25. Are signature plates under the signer's control when in use?	—	—					
26. Is the recording machine read by the signer or an appropriate designee to ascertain that all checks or warrants signed are properly accounted for by comparison to document control totals?	—	—					
27. Are signed warrants or checks delivered directly to the mailroom making them unaccessible to persons who requested, prepared, or recorded them?	—						
28. Is the drawing of warrants or checks to cash or bearer prohibited?	—						
Custody							
29. Are controls maintained over the supply of unused and voided warrants or checks?	—	—					
30. Are bank accounts properly authorized?		—					
31. Are depositories periodically reviewed and formally reauthorized?		—					
32. Do controls and physical safeguards exist surrounding working (petty cash) funds?	—						

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Completeness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
33. Is adequate fidelity insurance maintained?	—	—	—				
34. Are separate bank accounts maintained for each fund, or if not, is there adequate fund control over pooled cash?			—		—		
Detail Accounting							
35. Do procedures exist to ensure that collections and disbursements are recorded accurately and promptly?		—		—	—		
36. Do procedures exist for authorizing and recording interbank and interfund transfers and for providing for proper accounting for those transactions?	—	—		—	—		
General Ledger							
37. Does general ledger control exist over all bank accounts?	—	—					
38. Are bank statements and paid warrants or checks delivered in unopened envelopes directly to the employee preparing the reconciliation?	—	—			—		
39. Do procedures exist for steps essential to an effective reconciliation, particularly—							
● Comparison of warrants or checks in appropriate detail with disbursement records?		—		—			
● Examination of signature and endorsements, at least on a test basis?	—		—				
● Accounting for numerical sequence of warrants or checks used?		—		—			
● Comparison of book balances used in reconciliations with general ledger accounts?	—	—		—	—		
● Comparison of deposit amounts and dates with cash receipt entries?		—		—			
● Footing of cash books?		—		—			
40. Are all reconciliations and investigations of unusual reconciling items reviewed and approved by an official who is not responsible for receipts and disbursements, including recording evidence of the review and approval by signing the reconciliation?	—	—		—			
41. Are checks outstanding for a considerable time periodically reviewed for propriety?	—						
Phase 1: Preliminary Risk Assessment	L M H	L M H	L M H	L M H	L M H		
Phase 2: Final Risk Assessment—Based on audit tests of controls	L M H	L M H	L M H	L M H	L M H		

.200 B. Investments

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Completeness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
Segregation of Duties							
1. Are responsibilities for initiating, evaluating, and approving transactions segregated from those for detail accounting, general ledger, and other related functions?	—	—		—			
2. Are responsibilities for initiating transactions segregated from those for final approvals that commit government resources?	—			—			
3. Are responsibilities for monitoring investment market values and performance segregated from those for investment acquisition?	—			—			
4. Are responsibilities for maintaining detail accounting records segregated from those for general ledger entries?	—			—			
5. Are custodial responsibilities for securities or other documents evidencing ownership or other rights assigned to an official who has no accounting duties?	—		—	—			
6. If EDP is used, is the principle of segregation of duties within processing activities maintained?	—	—					
Procedural Controls							
Approval							
7. If applicable, are procedures adequate to ensure that only investments that are permitted by law are acquired?	—			—	—		
8. Are investment policy guidelines formally established and periodically reviewed?	—				—		
9. Is the investment program integrated with the cash management program and expenditure requirements?	—	—		—			
10. Have authority and responsibility been established for investment opportunity evaluation and purchase?	—			—			
11. Is the performance of the investment portfolio periodically evaluated by persons independent of investment portfolio management activities?	—	—		—			
12. Are procedures formally established governing the level and nature of approvals required to purchase or sell an investment?	—			—			
13. Are competitive bids sought for certificate of deposit purchases?	—			—			
Custody							
14. Do adequate physical safeguards and custodial procedures exist over—							
● Negotiable and nonnegotiable securities owned?	—		—				
● Legal documents or agreements evidencing ownership or other rights?	—		—				
15. Are dual signatures or authorizations required to obtain release of securities from safekeeping or to obtain access to the government unit's safe deposit box?	—		—				
16. Are persons with access to securities authorized by the legislative body?	—	—	—				
17. Are all securities registered in the name of the government unit?	—		—				
18. Are securities periodically inspected or confirmed from safekeeping agents?	—		—	—			
19. Are individuals with access to securities bonded?			—				
Detail Accounting							
20. Are detail accounting records maintained for investments?	—	—		—	—		
21. Do procedures exist to ensure that transactions arising from investments are properly processed, including income and amortization entries?	—	—		—	—		

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Complete-ness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
22. Do controls exist to ensure that investment earnings are credited to the fund from which resources were provided for the investment?				—	—		
23. Are periodic comparisons made between income received and the amount specified by the terms of the security or publicly available investment information?	—			—	—		
24. Do controls exist to ensure that transactions are recorded on a timely basis?		—		—	—		
General Ledger							
25. Do procedures exist for reconciling the detail accounting records with the general ledger control?	—			—	—		
26. Is the nature of investments included in general ledger balances periodically reviewed?	—			—	—		
Phase 1: Preliminary Risk Assessment	L M H	L M H	L M H	L M H	L M H		
Phase 2: Final Risk Assessment—Based on audit tests of controls.	L M H	L M H	L M H	L M H	L M H		

.210 C. Revenues and Receivables

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Completeness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
Segregation of Duties							
1. Are the responsibilities for billing property taxes and services segregated from collection and accounting?		—		—			
2. Are the responsibilities for maintaining detail accounts receivable records segregated from collections and general ledger posting?	—	—		—			
3. Are the collection, control, and deposit of funds activities segregated from the accounting records maintenance function?	—	—		—			
4. Are property tax assessment rolls maintained by individuals not engaged in any accounting or collection function?	—	—		—			
5. Are responsibilities for entries in the cash receipts records segregated from those for general ledger entries?	—	—					
6. If EDP is used, is the principle of segregation of duties within processing activities maintained?	—	—					
Procedural Controls							
Data and File Maintenance							
Property taxes							
7. Do controls exist to ensure that additions, deletions, transfers, and abatements are properly and timely reflected in property tax records?		—		—			
8. Do procedures exist to make property assessments in accordance with the law or legislative intent with prompt adjustment of records?		—	—	—			
Sales, income, and other taxes							
9. Are filed returns cross-referenced against a data base of previous taxpayers?		—					
10. Are records organized and integrated in such a fashion that probable taxpayers are identified as a result of reporting of other governmental activities such as licensing?		—					
License fees and permits							
11. If annual payments are involved, do procedures exist to ensure that previous years' records are properly updated for new registrants and withdrawals?	—	—					
12. Are updated records used as the basis for billing persons subject to payment?		—		—			
Fines, forfeitures, and court fees							
13. Are court and other records of payments due maintained and used as a basis for collections?		—		—			
14. Do procedures exist surrounding the control, issuance, and disposition of traffic violations to ensure that amounts due are assessed and collected?		—					
Enterprise and other service revenues							
15. Are controls maintained that provide assurances that customer data base and, where appropriate, usage records are accurately maintained to ensure that amounts due are billed?	—	—					
Billing/Remittance Verification							
Property taxes							

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Completeness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
16. Do controls exist within the billing system to ensure that eligible property owners are billed?		—		—			
17. Do controls exist to ensure that tax assessments are being properly applied against tax rates and special charges are being considered in the preparation of billing amounts?			—	—			
18. Do controls exist to ensure that tax exemptions are within the law and properly approved?	—		—	—			
Sales, income, and other taxes							
19. Are returns reviewed for mathematical accuracy?				—			
20. Are current year's taxpayers' returns correlated with prior year's returns and are differences reviewed and accounted for?		—		—			
21. Are claims for refunds reviewed and approved separately?	—		—	—			
22. Are audits of returns filed to provide reasonable assurance that taxable income is properly reported?			—	—			
License fees and permits							
23. Are current year receipts compared to those for prior years and are explanations of variations reviewed by senior officials?		—		—			
Fines, forfeitures, and court fees							
24. Do procedures exist providing for correlation of amounts collected with records of court proceedings?	—	—	—	—			
25. Are tickets for fines, arrests, and so forth sequentially numbered and satisfactorily accounted for?		—					
Enterprise and other service revenues							
26. If billing is based on usage, are service readings performed in a timely fashion?	—	—	—				
27. Are assignments of meter readers periodically rotated?		—	—				
28. Do billing procedures exist providing for identification and investigation of unusual patterns of use?	—	—					
General							
29. Are taxes and fees billed in a timely fashion?		—					
30. Do procedures exist designed for other revenue areas ensuring timely payment of amounts due?		—	—	—			
31. Are rates of taxes, fines, fees, and services periodically reviewed and approved by the legislative body?			—	—			
32. Are programs of tax exemption or relief periodically reviewed and approved by the legislative body?			—	—			
33. Are utility rate schedules authorized by the legislative body?			—	—			
34. Do procedures exist providing for timely notification of the accounting department at the time tax, service, or other billings or claims are prepared and rendered?		—		—			
35. Do numerical or batch-processing controls exist over tax, fee, service, or other billings?		—					
36. Do controls exist over the billing of miscellaneous revenues (for example, sidewalk replacement and tree removal assessments)?	—	—	—	—			
37. Do procedures exist to prevent the interception or alteration by unauthorized persons of billings or statements after preparation but before they are mailed?		—		—			
38. Does an individual independent of receivables record keeping promptly investigate disputes with billing amounts that are reported by taxpayers or service recipients?	—		—	—			

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Complete-ness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
39. Do controls exist providing reasonable assurances that restricted revenues are expended only for restricted purposes?			—	—	—		
Collection							
40. Is restrictive endorsement placed on incoming checks as soon as received?		—					
41. Do procedures exist providing reasonable assurances that interest and penalties are properly charged on delinquent taxes, fees, or charges for service?		—	—	—			
42. Do procedures exist providing for the timely filing of liens on property for nonpayment in all cases permitted by law?			—				
43. Do controls exist surrounding the collection, timely deposit, and recording of collections in the accounting records at each collection location?		—					
44. Is the general accounting department notified of cash receipts from separate collection centers on a timely basis?		—					
45. If payments are made in person, are receipts for payment used and accounted for and balanced to collections?	—	—					
46. Are amounts collected on behalf of other governments segregated and remitted on a timely basis?			—	—	—		
47. Are taxes and fees collected by another unit of government monitored to assure timely receipt and are amounts received subjected to reviews for reasonableness?		—	—	—			
48. Are delinquent accounts reviewed and considered for charge-off on a timely basis?			—	—	—		
49. Are write-offs or other reductions of receivables formally approved by senior officials not involved in the collection function?					—		
50. Do procedures exist providing for execution of all legal remedies to collect charged-off or uncollectible accounts, including tax sale of property, liens, and so forth?				—	—		
Accounts Receivable Record Keeping							
51. Do controls in the system exist that provide assurances that individual receivable records are posted only from authorized source documents?	—			—			
52. Are aggregate collections on accounts receivable reconciled against postings to individual receivable accounts?		—		—			
53. Are statements of account balance mailed on a timely basis, where appropriate (for example, in proprietary funds)?			—	—			
General Ledger							
54. Are trial balances of individual receivable accounts prepared on a timely basis?				—			
55. Are trial balances reconciled with general ledger control accounts and are reconciling items investigated by someone other than accounts receivable clerks?		—		—			
56. Are aged accounts receivable balances periodically reviewed by supervisory personnel?				—	—		
57. Do procedures exist providing for timely and direct notification of the accounting department of billings and collection activities?		—		—			
Grant and Entitlement Monitoring							
Grants							
58. Is responsibility for monitoring grant activities properly fixed?			—				
59. Is grant activity monitored from a centralized location?	—		—				
60. Do procedures exist to monitor compliance with—							
• Financial reporting requirements?			—				

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Completeness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
● Use of funds and other conditions in accordance with grant terms?	—		—	—			
● Timely billing of amounts due under grants?		—	—				
61. Is grant activity accounted for so that it can be separated from the accounting for locally funded activities?				—	—		
62. Is there a system for obtaining grantor approval before incurring expenditures in excess of budgeted amounts or for unbudgeted expenditures?			—				
63. Are grant revenues and disbursements processed under the same degree of controls applicable to the organization's other transactions (budget, procurement, etc.)?	—	—	—	—	—		
64. Are requirements included in subgrantee agreements that the subgrantee comply with the primary grant agreement conditions as well as the grantee's standards?			—				
65. Do reasonable procedures and controls exist to provide assurances of compliance with recipient eligibility requirements established by grants?			—				
66. Is an indirect cost allocation plan established?	—		—	—			
67. Is the plan approved by all grantor agencies?			—	—			
68. Is audit cognizance established for rates generated by the plan?				—			
Entitlements							
69. Is the amount of funds received compared with the amount anticipated by a responsible official and are unusual variances investigated?		—		—			
70. Do procedures exist to ensure that funds received are spent in accordance with legal requirements and spending restrictions?			—				
71. Are statistical or data reports that form the basis for revenue distribution reviewed by a responsible official before submission?	—			—			
Phase 1: Preliminary Risk Assessment	L M H	L M H	L M H	L M H	L M H		
Phase 2: Final Risk Assessment—Based on audit tests of controls	L M H	L M H	L M H	L M H	L M H		

.220 D. Capital Assets

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Complete-ness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
Segregation of Duties							
1. Are responsibilities for initiating, evaluating, and approving capital expenditures, leases, and maintenance or repair projects segregated from those for project accounting, property records, and general ledger functions?	—	—					
2. Are responsibilities for initiating capital asset transactions segregated from those for final approvals that commit government resources?	—	—		—			
3. Are responsibilities for the project accounting and property records functions segregated from the general ledger function?	—	—		—			
4. Are responsibilities for the project accounting and property records functions segregated from the custodial function?	—	—					
5. Are responsibilities for the periodic physical inventories of capital assets assigned to responsible officials who have no custodial or record keeping responsibilities?	—	—					
6. If EDP is used, is the principle of segregation of duties maintained within processing activities?		—					
Procedural Controls							
Authorization							
7. Are those individuals authorized to initiate capital asset transactions identified and is there clear definition of the limits of their authority?	—						
8. Are guidelines established with respect to key considerations such as prices to be paid, acceptable vendors and terms, asset quality standards, and the provisions of grants or bonds that may finance the expenditures?	—						
9. Is a separate capital projects budget prepared?	—						
Executive or Legislative Approval							
10. Is written executive or legislative approval required for all significant capital asset projects or acquisitions?	—						
11. Do procedures exist for authorizing, approving, and documenting sales or other dispositions of capital assets?	—	—					
12. Do procedures exist for approving decisions regarding financing alternatives and accounting principles, practices, and methods?	—			—			
13. Do procedures exist providing for obtaining grantor (federal/state) approval, if required, for the use of grant funds for capital asset acquisitions?	—		—				
14. Are grant-funded acquisitions subjected to the same controls as internally funded acquisitions?	—	—					
15. Are supplemental authorizations required, including, if appropriate, those of the grantor agency, for expenditures in excess of originally approved amounts?	—	—					
Project Accounting							
16. Is a qualified employee or independent firm engaged to inspect and monitor technically complex projects?	—	—		—			
17. Are project cost records established and maintained for capital expenditure and repair projects?	—	—		—			
18. Do reporting procedures exist for in-progress and completed projects?					—		
19. Do procedures exist to identify completed projects so that timely transfers to the appropriate accounts can be made?	—	—			—		

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Complete-ness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
20. Is the accounting distribution reviewed to ensure proper allocation of charges to fixed asset and expenditure projects?				—	—		
21. If construction work is performed by contractors, do procedures exist to provide for and maintain control over construction projects and progress billings?	—		—	—			
22. Does the unit of government have the right to audit contractors' records?	—	—	—	—			
23. Is the right to audit contractor records during project performance exercised?	—		—				
24. Do audits of contractors cover compliance with EEO, Davis Bacon, and other regulations and contract terms, in addition to costs?	—	—		—	—		
Asset Accountability							
25. Are detail property records maintained for all significant self-constructed, donated, purchased, or leased assets?	—	—					
26. Is the accountability for each asset established?	—	—					
27. Do procedures exist for periodic inventory of documents evidencing property rights (for example, deeds, leases, and the like)?	—	—		—			
28. Do physical safeguards over assets exist?	—	—					
29. Do procedures exist ensuring that purchased materials and services for capital expenditure and repair projects are subjected to the same levels of controls as exist for all other procurements (for example, receiving, approval, checking)?	—	—					
30. Are detailed property records periodically compared with existing assets?	—	—		—			
31. Are differences between records and physical counts investigated and are the records adjusted to reflect shortages?	—			—			
32. Do procedures exist ensuring that capital assets are adequately insured?	—			—			
33. Are lease transactions subjected to control procedures similar to those required for other capital expenditures?	—	—	—				
34. Is equipment properly identified by metal numbered tags or other means of positive identification?	—			—			
35. Are fully depreciated assets carried in the accounting records as a means of providing accounting control?	—	—					
36. Do procedures exist for monitoring the appropriate disposition of property acquired with grant funds?	—		—				
General Ledger							
37. Are detailed property records periodically reconciled with the general ledger control accounts?	—	—		—			
38. Do procedures and policies exist to—							
● Distinguish between capital projects' fund expenditures and operating budget expenditures?			—	—			
● Identify operating budget expenditures to be capitalized in the fixed asset fund?					—		
● Distinguish between capital and operating leases?			—		—		
● Govern depreciation methods and practices?				—			
39. If costs are expected to be charged against federal grants, are depreciation policies or methods of computing allowances in accord with the standards outlined in OMB circulars or grantor agency regulations; if not, is depreciation charged to grants adjusted accordingly?			—	—			
40. Are the accounting records adjusted promptly—both the asset and related allowance for depreciation—when items of plant and equipment are retired, sold, or transferred?	—		—	—	—		

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Completeness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
Phase 1: Preliminary Risk Assessment	L M H	L M H	L M H	L M H	L M H		
Phase 2: Final Risk Assessment—Based on audit tests of controls	L M H	L M H	L M H	L M H	L M H		

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Complete-ness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
.230 E. Procurement and Payables							
Segregation of Duties							
1. Are responsibilities for the requisitioning, purchasing, and receiving functions segregated from the invoice processing, accounts payable, and general ledger functions?	—	—					
2. Are responsibilities for the purchasing function segregated from the requisitioning and receiving functions?	—	—					
3. Are responsibilities for the invoice processing and accounts payable functions segregated from the general ledger functions?	—	—		—			
4. Are responsibilities for the disbursement preparation and disbursement approval functions segregated from those for recording cash disbursements and general ledger entries?	—	—		—			
5. Are responsibilities for the disbursement approval function segregated from those for the disbursement preparation function?	—	—					
6. Are responsibilities for entries in the cash disbursement records segregated from those for general ledger entries?	—	—		—			
7. If EDP is used, is the principle of segregation of duties maintained within processing activities?	—	—					
Procedural Controls							
Requisitioning							
8. Are purchases of goods and services initiated by properly authorized requisitions bearing the approval of officials designated to authorize requisitions?	—						
9. Are requisitions pre-numbered and are those numbers controlled?	—	—					
10. Is the appropriation to be charged indicated on the purchase requisition by the person requesting the purchase?	—				—		
11. Before commitment, are unobligated funds remaining under the appropriation verified by the accounting or budget department as sufficient to meet the proposed expenditure?			—	—			
12. Are requests for special purpose (nonshelf items) materials or personal services accompanied by technical specifications?	—			—			
Purchasing							
13. Are purchasing authorizations structured to give appropriate recognition to the nature and size of purchases and the experience of purchasing personnel?	—	—					
14. Do approval procedures exist for purchase order and contract issuance?	—	—					
15. Are purchase prices periodically reviewed by a responsible employee independent of the purchasing department?				—			
16. Are competitive bidding procedures used?				—			
17. If practicable, are contract or purchasing officer's areas of responsibility rotated on a regular basis?	—						
18. Do provisions in contracts for materials, services, or facilities acquired on other than a fixed price basis provide for an audit of contractors' costs, with payments subject to audit results?			—	—			
19. Do procedures exist for public advertisement of nonshelf item procurements in accordance with legal requirements?	—			—			
20. Are recurring purchases and documentation of the justification for informal rather than competitive bids periodically reviewed?	—			—			
21. Are policies regarding conflicts of interest and business practice policies established, documented, and distributed?	—						
22. Are purchase orders and contracts issued under numerical or some other suitable control?	—	—					

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Completeness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
23. Are an adequate number of price quotations obtained before placing orders not subject to competitive bidding?				—			
24. Is splitting orders prohibited to avoid higher levels of approval?	—			—			
25. Are price lists and other appropriate records of price quotations maintained by the purchasing department?				—			
26. Is a record of suppliers who have not met quality or other performance standards by the purchasing department maintained?	—	—					
27. Are procedures modified when funds disbursed under grant or loan agreements and related regulations impose requirements that differ from the organization's normal policies?	—		—		—		
28. Are procedures instituted to identify, before order entry, costs and expenditures not allowable under grant (federal/state) programs?			—	—			
29. Is an adequate record of open purchase orders and agreements maintained?	—		—				
30. Are purchases made for the accommodation of employees prohibited or adequately controlled?	—			—			
31. If construction contracts are to be awarded, are bid and performance bonds considered?	—		—	—			
32. Does predetermining selection criteria exist for awarding personal service or construction contracts and is adequate documentation of the award process required?				—			
33. Are changes to contracts or purchase orders subjected to the same controls and approvals as the original agreement?			—	—			
Receiving							
34. Are receiving reports prepared for all purchased goods?	—						
35. Do procedures exist for the filing of claims against carriers or vendors for shortages or damaged materials?	—		—	—			
36. Are steps taken to ensure that goods received are accurately counted and examined to see that they meet quality standards?	—			—			
37. Is a permanent record of material received by the receiving department maintained?	—	—		—			
38. Are receiving reports numerically accounted for or otherwise controlled to ensure that all receipts are reported to the accounting department?	—	—		—			
39. Are copies of receiving reports sent directly to purchasing, accounting, and, if appropriate, inventory record keeping?	—	—		—			
40. Is a government technical representative assigned to monitor and evaluate contractor performance and approve receipt of services with respect to procurements of special purpose materials, services, or facilities?	—	—		—			
41. If a receiving department is not used, do adequate procedures exist to ensure that goods for which payment is made have been received and are verified by someone other than the individual approving payment that goods have been received and meet quality standards?	—	—		—			
Invoice Processing							
42. Do invoice processing procedures provide for—							
• Obtainment directly from issuing departments of copies of purchase orders and receiving reports?	—	—					
• Comparison of invoice quantities, prices, and terms with those indicated on the purchase order?		—		—			
• Comparison of invoice quantities with those indicated on the receiving reports?		—		—			
• As appropriate, checking accuracy of calculations?				—			

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
43. Are all invoices received from vendors in a central location, such as the accounting department?		—					
44. Do procedures exist ensuring that the accounts payable system is properly accounting for unmatched receiving reports and invoices?	—	—	—	—			
45. Are requests for progress payments under long-term contracts related to contractors' efforts and are they formally approved?	—		—	—			
46. Do procedures exist for processing invoices not involving materials or supplies (for example, lease or rental payments, utility bills)?	—	—					
47. Do procedures exist ensuring accurate account distribution of all entries resulting from invoice processing?	—			—	—		
48. If applicable, is access to the EDP master vendor file limited to employees authorized to make changes?	—	—					
49. Does the accounting department maintain a current list of those authorized to approve expenditures?	—						
50. Do procedures exist for submission and approval of reimbursement to employees for travel and other expenses?	—		—	—			
51. Is control established by the accounting department over invoices received before releasing them for departmental approval and other processing?	—	—		—			
52. Is the distribution of charges in the accounting department reviewed by a person competent to pass on the propriety of the distribution?				—	—		
53. Are invoices (vouchers) reviewed and approved for completeness of supporting documents and required clerical checking by a senior employee?	—	—					
54. If an invoice is received from a supplier not previously dealt with, are steps taken to ascertain that the supplier actually exists?	—						
55. Are payments made only on the basis of original invoices?	—			—			
56. Is responsibility fixed for seeing that all cash discounts are taken and, if applicable, that exemptions from sales, federal excise, and other taxes are claimed?				—			
57. Are differences in invoice and purchase order price, terms, shipping arrangements, or quantities referred to purchasing for review and approval?	—			—			
58. Does the accounting department record and follow up partial deliveries?		—		—			
59. Are the accounting and purchasing departments promptly notified of returned purchases, and are such purchases correlated with vendor credit advices?	—			—			
60. Is the program and expenditure account to be charged reviewed for propriety and budget conformity?				—	—		
61. Do check signers or other responsible officials determine that restricted revenues are expended only for restricted purposes?			—		—		
62. If applicable, do procedures exist to ensure adjustment of the reserve for encumbrances (obligations) when invoices are prepared for payment?	—			—	—		
Disbursements							
63. Do procedures exist for disbursement approval and warrant or check-signing?	—	—					
64. Is there control over warrant or check-signing machines as to signature plates and usage?	—						
65. Do procedures exist to notify banks when a new signer is authorized or a previous signer leaves the employ of the government?	—						
66. Is the signer furnished with invoices and supporting data and are they reviewed prior to signing the warrant or check?	—	—		—			

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Complete-ness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
67. Are reasonable limits set on amounts that can be paid by facsimile signatures?	—						
68. Are two signatures required on all warrants or checks over a stated amount?	—						
69. Are signature plates maintained in the custody of the person whose facsimile signature is on the plate when not in use?	—						
70. Are plates only under the signer's control used and does that person or an appropriate designee record machine readings to ascertain that all checks or warrants signed are properly accounted for?	—			—			
71. Are invoices and supporting documents cancelled by or in the presence of the signer at the time of signing?	—			—			
72. Are signed warrants or checks delivered directly to the mail room, making them inaccessible to persons who requested, prepared, or recorded them?	—						
73. Are warrants or checks cross-referenced to vouchers?	—			—			
74. Are warrants or checks controlled and accounted for with safeguards over those unused and voided?	—	—					
75. Is the drawing of warrants or checks to cash or bearer prohibited?	—						
76. Do procedures exist ensuring that warrants or checks that have been signed and issued are recorded promptly?	—	—		—	—		
Accounts Payable Encumbrances or Obligations							
77. Are statements from vendors compared on a regular basis with recorded amounts payable?	—			—			
78. If an encumbrance (obligation) system is used, are outstanding purchase orders reconciled to the reserve for encumbrances (obligations) on a monthly basis?	—			—	—		
79. Are encumbrance (obligation) entries recorded only on the basis of approved purchase orders?	—				—		
80. Do procedures exist ensuring that accounts payable and encumbrances (obligations) are applied against the appropriate account?	—			—	—		
81. Do procedures exist ensuring that department heads are notified of payments made against accounts payable and encumbrances (obligations)?	—			—	—		
General Ledger							
82. Are trial balances of reserve for encumbrances (obligations) and accounts payable prepared on a regular basis?		—		—	—		
83. Are trial balance footings checked and traced to the individual items as well as comparing the total to the general ledger balance by an employee other than the accounts payable clerk?		—		—	—		
84. Are transactions between funds in all affected funds posted in the same accounting period and on a timely basis?				—	—		
Grant and Entitlement Monitoring							
85. Are grants disbursed only on the basis of approved applications?	—			—			
86. Are reporting and compliance requirements defined (for example, in regulations) and communicated to grantees?					—		
87. Do procedures exist to monitor grantee compliance with grant terms?			—		—		
88. Are financial operations of grantees subjected to periodic and timely audit?	—	—	—	—			
89. Are recipients monitored sufficiently and on a timely basis to permit curtailment of any abuse before complete funds disbursement?	—	—	—	—			

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Complete-ness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
90. Are funds disbursed to grantees only on an as-needed basis?	—			—			
91. Does the level of grant approval authority appear appropriate?	—	—					
92. Is failure by grantees to meet financial reporting requirements investigated on a timely basis?			—	—	—		
93. Are grantees required to evidence correction of previously detected deficiencies before approval of an extension or renewal of a grant?	—		—		—		
94. Do entitlement procedures exist ensuring that statistics or data used to allocate funds are accurately accumulated (for example, census bureau forms)?				—	—		
95. Are statements of recipient compliance required with entitlement conditions (for example, statement of assurances) to be filed and does a responsible official review them?			—		—		
96. Are audited financial statements or other compliance requirements of entitlement recipients reviewed on a timely basis and are unusual items investigated?			—	—	—		
Phase 1: Preliminary Risk Assessment	L M H	L M H	L M H	L M H	L M H		
Phase 2: Final Risk Assessment—Based on audit tests of controls	L M H	L M H	L M H	L M H	L M H		

	Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Audit Tests of Controls: Program or W/P Reference	Substantive Tests: Program Reference
.240 F. Employee Compensation							
Segregation of Duties							
1. Are responsibilities for supervision and timekeeping functions segregated from personnel, payroll processing, disbursement, and general ledger functions?	—	—					
2. Are responsibilities for the payroll processing function segregated from the general ledger function?	—	—		—			
3. Is payroll distribution supervised by employees—							
● Who are not responsible for hiring or firing employees?	—						
● Who do not approve time reports?	—						
● Who take no part in payroll preparation?	—						
4. Are responsibilities for initiating payments under employee benefit plans segregated from accounting and general ledger functions?	—	—		—			
5. Is the payroll bank account reconciled regularly by employees independent of all other payroll transaction processing activities?	—	—		—			
6. If EDP is used, is the principle of segregation of duties maintained in processing activities?	—	—					
Procedural Controls							
Personnel							
7. Are all changes in employment (additions and terminations), salary and wage rates, and payroll deductions properly authorized, approved, and documented?	—	—		—			
8. Are notices of additions, separations, and changes in salaries, wages, and deductions promptly reported to the payroll-processing function?		—		—			
9. Are appropriate payroll records maintained for accumulated employee benefits (vacation, pension data, etc.)?		—		—			
10. Are terminating employees interviewed as a check on departure and as a final review of any termination settlement by the personnel department?	—	—		—			
11. Do written personnel policies exist?	—	—					
12. Are controls established to ensure that payroll costs charged to grants are in compliance with grant agreements?				—	—		
13. Are payroll and personnel policies governing compensation in accordance with the requirements of grant agreements?			—	—			
14. Are wages at or above the federal minimum wage?				—			
Supervision/Timekeeping							
15. Are hours worked, overtime hours, and other special benefits reviewed and approved by the employee's supervisor?	—	—		—			
16. Do records and procedures exist for timekeeping and attendance?	—	—					
17. Are time cards or other time reports reviewed for completeness and approved by the employee's supervisor?	—	—					
18. If time cards are used, are they punched only by the employees to whom they are issued?	—						
19. Is the time clock placed in a position where it can be observed by a supervisor?	—						
20. Do procedures exist for authorizing, approving, and recording vacations, holidays, and sick leave and is compensatory time controlled and approved?	—			—	—		
Payroll Processing							
21. Do controls exist over payroll preparation?	—	—		—			

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
22. Are changes to the EDP master payroll file approved and documented?	—			—			
23. Is access to the EDP master payroll file limited to employees who are authorized to make changes?	—			—			
24. Are completed payroll registers reviewed and approved before disbursements are made?	—			—			
25. Are documents supporting employee benefit payments (such as accumulated vacation or sick leave) reviewed before disbursements are made?	—	—		—			
26. Are comparisons (reconciliations) of gross pay of current to prior period payrolls reviewed for reasonableness by a knowledgeable person not otherwise involved in payroll processing?	—	—		—			
27. Is the payroll (examination of authorizations for changes noted on reconciliations) reviewed by an employee not involved in its preparation?	—	—		—			
28. Is the distribution of dollars and hours of gross pay balanced with the payroll registers, and reviewed by someone independent but knowledgeable in this area?				—	—		
29. Is a comparison to amounts appropriated and budgeted included in the review?				—	—		
30. Are payroll advances to officials and employees prohibited or are they subjected to appropriate review?	—			—	—		
Disbursement							
31. Are signature plates and the use of the payroll check-signing machines kept under control of the official whose name appears on the signature plate or an employee to whom he has delegated that responsibility?	—						
32. Is a log maintained that reconciles the counter on the check-signing machine with the number of checks issued in each payroll?	—						
33. Is a separate, imprest-basis, payroll bank account maintained?	—			—			
34. Is the payroll bank account reconciled on a regular basis?	—			—			
35. Are payroll check endorsements compared, on a test basis, with signatures on file by someone independent of the payroll department?	—						
36. Is someone independent of the payroll department comparing payments made in cash, which require signed receipts, with signatures on file on a test basis?	—			—			
37. Is the supply of unused payroll checks controlled?	—			—			
38. Are employees required to provide identification before being given checks or pay envelopes?	—			—			
39. Are employees prohibited from accepting another employee's pay?	—						
40. Are unclaimed wages returned to a custodian independent of the payroll department?	—				—		
41. Do employees who distribute checks or pay envelopes make a report of unclaimed wages directly to the accounting department?	—				—		
42. Are payments of unclaimed wages made at a later date only upon presentation of appropriate evidence of employment and are they approved by an officer or employee who is not responsible for payroll preparation or time reporting?	—						
43. Are W-2 forms compared to payroll records and mailed by employees not otherwise involved in the payroll process?		—		—			
44. Do procedures exist for investigating returned W-2s?	—			—			
45. Are payroll checks periodically distributed by the internal auditors to ascertain that employees exist for all checks prepared?	—						

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Complete-ness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
General Ledger							
46. Do adequate account coding procedures exist for classification of employee compensation and benefit costs so that such costs are recorded in the proper general ledger account?					—		
47. Are accrued liabilities for unpaid employee compensation and benefit costs properly recorded or disclosed?		—	—	—	—		
Phase 1: Preliminary Risk Assessment	L M H	L M H	L M H	L M H	L M H		
Phase 2: Final Risk Assessment—Based on audit tests of controls	L M H	L M H	L M H	L M H	L M H		

IV. Administrative Controls

.250 When conducting audits in accordance with the Single Audit Act of 1984, the auditor needs to identify the administrative controls that need to be in place in order to properly administer its federal assistance programs.

.260 These controls are normally established by an entity based on the major requirements with which the entity must comply. Paragraphs .270 and .280 are common control procedures which need to be documented and tested to support the auditor's report on internal administrative controls.

.270 A. General Compliance Requirements

1. Political Activity (Compliance Supplement)

a. Ordinances prohibiting partisan political activity.
b. Posters stating the prohibition against partisan political activity.
c. Employee policy statement, handbook or policy manual prohibiting partisan political activity.
d. Expenditure approval process, i.e., expenditures reviewed by a person who is knowledgeable of this restriction.

2. Davis-Bacon Act (Compliance Supplement)

a. The practice of obtaining prevailing wage rates published in the Federal Register or obtained from the Department of Labor and comparing these rates with rates paid by contractors or subcontractors based on payroll records submitted to the grantee.

b. The practice of interviewing contractors' or subcontractors' laborers to verify their wage rates and to compare them to the prevailing wage rate.

c. The practice of posting prevailing wage rates and the provisions of the Davis-Bacon Act at job sites.

d. Existence of provisions in contracts expressly requiring compliance with Davis-Bacon Act.

e. Assignment of responsibility to monitor contractors for compliance with contract terms, including Davis-Bacon provision.

f. Periodic requests of the Division of Labor Standards for their findings regarding the existence of any discriminatory practices by the grantee.

3. Civil Rights (Compliance Supplement)

a. Existence of a civil rights policy—prohibiting discrimination.

b. Existence of an affirmative action policy—encouraging the use of minority firms and employment of individuals from minority groups.

c. Methods of communicating the civil rights/affirmative action policy such as posters, notations on letterhead, etc.

d. Accumulation of data and preparation of periodic reports reflecting status in achieving affirmative action goals.
e. Designated compliance officer to receive and process civil rights inquiries and complaints.

f. Self-evaluation procedures to ensure compliance by grantee.

g. Practice of holding open meetings to ensure the public is knowledgeable of the grantee's management philosophy and major policy issues.

h. Practice of holding public hearings regarding such topics as the use of federal funds and the location of federally financed facilities.

i. Published grievance procedures.

j. Distribution of policies and grievance procedures via the employee handbook.

4. Cash Management (Compliance Supplement)

a. Practice of deferring request for reimbursement until after the related expenditure is incurred.

b. Existence of a cash log showing expenditures and cash balances for federal financial programs.

c. Assignment of responsibility for requesting grant drawdowns to a person who has access to and utilizes the cash log and is knowledgeable of the cash management requirements.

d. Utilization of adequate cash forecasting methods (when grant reimbursements are requested prior to incurring the expenditure).

e. Reviewed and documented approval of grant drawdown requests by a person knowledgeable of the cash management restrictions.

f. Inclusion of pertinent requirements in grantee's investment policy.

g. Depository agreement stipulating FDIC/FSLIC and segregation of account requirements.

h. Inclusion in requests for banking services of pertinent requirements.

5. Relocation Assistance and Real Property Acquisition (Compliance Supplement)

a. The existence of a policy statement compatible with federal regulations regarding relocation assistance and real property acquisition.

b. The existence of a "relocation officer," i.e., the assignment of a person to monitor compliance with federal requirements.

c. Proper training, copies of regulations and other procedures to ensure that persons responsible for administering programs involving relocation or real property acquisition are made aware of federal requirements.

d. Utilization of a checklist of federal requirements by persons responsible for administering programs involving relocation or real property acquisition.

e. Practice of sending pamphlets to persons being relocated, informing them of their rights and the prescribed procedures.

f. Practice of requesting written acknowledgement of persons being relocated that the required procedures and rights were made available to them.

g. Existence of a review function over the acquisition of real property for compliance with federal requirements.

6. Federal Financial Reports (Compliance Supplement)

a. Tickler file to ensure reports (including grant closeout reports) are filed timely (preferably centralized).

b. Assignment of responsibility for preparing reports (perhaps included as a duty in the employee's job description).

c. Policy of requiring review and written approval of federal financial reports for accuracy and timeliness of submission.

d. Periodic documented reconciliations of federal financial reports to the general ledger (or to work sheets that are reconciled to the general ledger).

7. Allowable Costs/Cost Principles (OMB Circular A-87)

a. Review of expenditures by a person knowledgeable of the provisions of OMB Circular A-87.

b. Involvement in the grant application/budget process by a person knowledgeable of the provisions of OMB Circular A-87.

c. Utilization of a checklist denoting allowable, unallowable and possibly unallowable costs by persons authorizing and/or reviewing expenditures charged to grant programs.

d. Existence of written policies regarding expenditures eligible for federal reimbursements.

e. Utilization of a person knowledgeable of indirect cost principles for preparation of the plan.

f. Assignment of responsibility for reviewing indirect cost allocations to a person knowledgeable of the requirements.

g. Periodic documented reconciliation of costs accumulated in the indirect cost pool to the general ledger.

h. Utilization of an outside expert to prepare or periodically review the indirect cost allocation plan and/or adherence to the plan.

8. Drug-Free Workplace Act

a. Existence of drug-free workplace policy.

b. Designated compliance officer.

c. Tickler file to ensure grant certifications are filed timely for each grant.

d. Checklist or sign-off sheet to ensure policy is distributed to employees paid with federal funds.

e. Assignment of responsibility for reporting violations to the Federal government.

9. Administrative Requirements (Common Rule)

a. Interest earned on advances:

(1) Existence of cash log showing interest earned on advances.

(2) Assignment of responsibility to remit such interest to appropriate Federal Agency at least quarterly.

b. Period of availability of funds:

(1) Review of expenditures to ensure charges result from obligations of the funding period unless carry-over of unobligated balances is permitted.

(2) Assignment of responsibility to liquidate all obligations incurred under the award no later than 90 days after the end of the funding period.

(3) Tickler file to ensure liquidation of obligations and submission of annual Financial Status Report (SF 269).

c. Program income:

(1) Establishment of records to track program income (and costs to generate program income if Federal Agency authorizes netting of income and costs).

(2) Assign responsibility for ensuring that current program income is deducted from current allowable costs in determining federal drawdowns or reimbursements.

(3) When authorized by Federal Agencies, assign responsibility of ensuring program income is used only in authorized manner. For example:

- program income is added to the total funds committed to the project; or
- program income is used to meet cost sharing or matching requirements.

(4) Establish a grant "Master Control" sheet that indicates how program income is to be used on each grant.

d. Real property:

(1) Maintenance of real property records, including sources of financing, percentage of federal ownership, cost, and other pertinent information.

(2) Periodic reviews made to ensure real property is used for the originally authorized purposes.

(3) Assign responsibility for obtaining disposition instructions for real property and disposing of real property no longer needed for the originally authorized purpose through:

- Retention of title.
- Sale of property.
- Transfer of title.

e. Equipment:

(1) Existence of fixed asset inventory system, which include sources of financing for fixed assets, percentage of federal ownership, location cost, and other pertinent information.

(2) Documentation in fixed asset manual of federal requirements relating to frequency of conducting inventory (every two years), transfer, property utilization, property disposition, and accounting.

(3) Review of fixed asset purchases, maintenance, safeguarding, transfers, and dispositions by a person knowledgeable of the requirements.

f. Supplies:

(1) Maintenance of inventory records of unused supplies.

(2) Establish a policy regarding unused and unneeded supplies and the requirement to compensate the awarding Agency for its share.

g. Subawards to debarred and suspended parties:

(1) Assign responsibility for ensuring that awards are not made to any debarred or suspended parties.

h. Procurement:

(1) Incorporation of federal procurement standards in grantee's purchasing policy.

(2) Knowledge of procurement-related restrictions by persons involved in the review and award of contracts.

(3) Review of purchase requisitions and/or purchase orders by persons knowledgeable of procurement requirements.

i. Subgrants:

(1) Inclusion of a provision for compliance with the Common Rule in every subgrant.

(2) Inclusion of other significant provisions in every subgrant.

(3) Policy to make subgrantees aware of the regulations imposed on them.

j. Revolving Fund repayments:

(1) Establish revolving fund records that include information necessary to track repayments.

(2) Establish policy to ensure repayments are made on a timely basis.

.280 B. Example of Specific Requirements

Major Program—Specific Compliance Requirements
Community Development Block Grant

Besides documenting and testing the internal administrative controls over the general compliance requirements, the internal administrative controls over program-specific requirements need to be documented and tested. The controls and control procedures may vary significantly among governments so the individual circumstances in a particular government need to be examined. This section provides an example of the types of questions that may be asked to provide information about internal administrative controls over specific program requirements.

A. Types of services allowed or unallowed

1. What control procedure does the entity have in place to ensure that activities funded by the program are for allowable purposes and meet one of the national objectives?
2. What control procedure does the entity have in place to ensure that not more than 20 percent of the total grant is expended for planning and administration?

B. Eligibility

The auditor is not expected to make tests for recipient eligibility.

C. Matching, level of effort, and/or earmarking requirements

There are no matching, level of effort, or earmarking requirements.

D. Reporting requirements

1. What control procedure does the entity use to ensure that the grantee performance report is fully completed and submitted within two months after the end of each program year?
2. What control procedures are in place to ensure other Federal reports required by the program are identified, fully completed and submitted on a timely basis?

E. Special tests and provisions

1. What control procedures exist to ensure that program funds are not obligated or expended before the receipt of HUD's approval of a Request for Release of Funds (RROF) and environmental certification?
2. How does the entity ensure that all projects requiring an environmental review receive one?
3. What procedures do you employ to ensure that income earned under this program, if any, is properly accounted for and utilized in accordance with federal laws and regulations?

4. Describe the accounting processing involved from initiating the transaction to its inclusion in the financial statements, including how the computer is used to process data.

   This understanding involves knowledge of the ways in which transactions are valued, classified, recorded, and summarized in the journals and ledgers.

   After gaining an understanding of the direct flow of accounting information from its origin through the processing system to its compilation in the general ledger, an understanding of the processing steps, including how transactions are valued, classified, recorded and summarized, and control points at each processing step needs to be obtained.

5. Describe the financial reporting process including the extent of client procedures to prepare significant accounting and disclosure estimates. Also, describe the way in which general ledger information is summarized to arrive at the amounts and disclosures reported in the financial statements.

[The next page is 4701.]

AAM Section 4700
The Auditor's Assessment of Control Risk

.01 Most of the auditor's work in forming an opinion on financial statements consists of obtaining and evaluating evidential matter concerning the assertions in such financial statements. SAS No. 31, *Evidential Matter,* (AU section 326), presents assertions as representations by management that are embodied in financial statement components. In obtaining evidential matter in support of financial statement assertions, the auditor develops specific audit objectives in light of those assertions. There is not necessarily a one to one relationship between audit objectives and audit procedures.

.02 Assertions are classified in SAS No. 31, according to the following broad categories:

- Existence or Occurrence. Reported assets and liabilities actually exist at the balance sheet date, and transactions reported in the income statement actually occurred during the period covered.
- Completeness. All transactions and accounts that should be included in the financial statements are included, and there are no undisclosed assets, liabilities or transactions.
- Rights and Obligations. The entity owns and has clear title to assets and liabilities are the obligations of the entity
- Valuation or Allocation. The assets and liabilities are valued properly and the revenues and expenses are measured properly.
- Presentation and Disclosure. The assets, liabilities, revenues, and expenses are properly classified, described, and disclosed in the financial statements.

.03 SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AU section 319), states that the auditor should assess control risk in terms of assertions for material components of the financial statements. Many practitioners may consider audit objectives that relate to the assertions when assessing control risk. SAS No. 55 does not preclude or require any specific approach as long as control risk is ultimately assessed at the assertion level. For example, an approach of identifying internal control structure policies and procedures and relating those to significant audit objectives for account balances or transaction classes would be appropriate. Practice aids for documenting the assessed level of control risk using this approach are illustrated in AAM section 4700.05—4700.09.

.04 The following workpapers for documenting control risk assessments would be prepared only for assertions with an assessed level of control risk below maximum. Based on the results of tests of controls, the auditor determines whether the initial assessment of control risk is appropriate. During planned tests of controls, the auditor may obtain additional evidence and perform additional tests of controls. The results of such tests may support a further reduction in the assessed level of control risk. Conversely, planned tests of controls may indicate that control policies and procedures are ineffective in design or operation. Such results may lead the auditor to assess control risk at maximum for the assertions affected.

.05

ABC Company

Assessment of Control Risk - 12/31/X5

Date	Prepared By	Work Paper No
	Reviewed By	

Transaction Class or Account Balance: Revenues	Financial Statement Existence Occurrence	Completeness	Rights/ Obligations
Relevant Internal Control Structure Policies/Procedures:			
1) Use of prenumbered shipping documents	✓	✓	N/A
2) Shipping documents matched with prenumbered invoices	✓	✓	N/A
3) EDP Functions segregated from users	N/A	✓	N/A
4) Sales and accounts receivable postings are reconciled	N/A	✓	N/A
5) Billing function segregated from collection function	N/A	✓	N/A
6) Recording of sales journal and subsidiary ledger segregated	N/A	N/A	N/A
7) Monthly statements sent to customers	✓	✓	N/A
8) Invoices are reviewed and verified	N/A	✓	N/A
Initial Assessment of Control Risk	Moderate	Low	N/A
Tests of Controls - W/P Ref.			
Final Assessment of Control Risk			

Assertions	
Valuation Allocation	Presentation/ Disclosure
N/A	N/A
N/A	N/A
✓	✓
✓	✓
✓	✓
✓	✓
N/A	N/A
N/A	N/A
Moderate	Moderate

.06

ABC Company
Assessment of Control Risk
12/31/X5

Date	Prepared By	Work Paper No
	Reviewed By	

Transaction Class or Account Balance: Cash Receipts	Financial Statement: Existence/ Occurrence	Completeness	Rights/ Obligations
Relevant ICS Policies and Procedures			
1) Handling of cash and record keeping are segregated	✓	✓	N/A
2) Use of prenumbered remittance advices or listings	N/A	✓	N/A
3) Independent verification of recording receipts	N/A	✓	N/A
4) Daily recording of receipts	N/A	✓	N/A
5) Bank accounts are reconciled monthly	✓	✓	✓
Initial Assessment of Control Risk	Moderate	Low	Low
Tests of Controls - W/P Ref.			
Final Assessment			

Assertions	
Valuation Allocation	Presentation/ Disclosure
✓	✓
✓	✓
	N/A
✓	
	N/A
✓	✓
✓	✓
Low	Moderate

.07

ABC Company

Assessment of Control risk

12/31/X5

Date	Prepared By	Work Paper No
	Reviewed By	

Transaction Class or Account Balance: Purchases	Financial Statement Existence/ Occurrence	Completeness	Rights/ Obligations
Relevant ICS Policies and Procedures			
1) Use of purchase requisitions, purchase orders, receiving reports and matching with vendor invoices	✓	N/A	✓
2) Cancellation of used documents	✓	N/A	N/A
3) Use of prenumbered documents	N/A	✓	N/A
4) Calculations and amounts are verified	N/A	N/A	N/A
5) Purchases recorded on timely basis	N/A		N/A
6) Use of voucher register, or subsidiary ledger	✓	✓	✓
7) Segregation of purchasing, cash disbursement and recording functions	N/A	N/A	N/A
8) Monthly reconcilation of subsidiary ledgers to control accounts	N/A	✓	N/A
Initial Assessment of Control Risk	Moderate	Moderate	High
Tests of Controls - W/P Ref.			
Final Assessment			

Assertions	
Valuation Allocation	Presentation/ Disclosure
N/A	N/A
N/A	N/A
N/A	N/A
✓	N/A
N/A	✓
✓	✓
✓	✓
✓	✓
Low	Low

.08

ABC Company

Assessment of Control Risk

12/31/X5

Date	Prepared By	Work Paper No
	Reviewed By	

Transaction Class or Account Balance: Cash Disbursements	Financial Statement: Existence/ Occurrence	Completeness	Rights/ Obligations
Relevant ICS Policies and Procedures			
1) Supporting documentation required for payments	✓	N/A	N/A
2) Custody of checks and accounts payable record keeping are segregated	✓	N/A	N/A
3) Use of prenumbered checks; Checks accounted for	N/A	✓	N/A
4) Cash accounts reconciled monthly	N/A	✓	N/A
5) Supporting documents are verified	N/A	N/A	N/A
6) Subsidiary A/P ledgers reconciled monthly to control account	N/A	N/A	N/A
Initial Assessment of Control Risk	Moderate	Moderate	N/A
Tests of Controls - W/P Ref.			
Final Assessment			

	5	6	7	8	9	10	
	Assertions						
	Valuation Allocation	Presentation/ Disclosure					
							1
							2
							3
	N/A	N/A					4
							5
							6
	✓	✓					7
							8
							9
	N/A	N/A					10
							11
	✓	✓					12
							13
	✓	✓					14
							15
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	✓	✓					17
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							36
							37
	Low	Low					38
							39
							40

.09

ABC Company
Assessment of Control Risk
12/31/X5

Date	Prepared By	Work Paper No
	Reviewed By	

Transaction Class or Account Balance: Payroll	Financial Statement: Existence/ Occurrence	Completeness	Rights/ Obligations
Relevant ICS Policies and Procedures			
1) Time cards or documents are approved by appropriate personnel	✓	N/A	N/A
2) Segregation of timekeeping, personnel and payroll functions	✓	N/A	N/A
3) Use of prenumbered payroll checks; Checks accounted for	N/A	✓	N/A
4) Payroll checking account reconciled monthly	N/A	✓	N/A
5) Review and verification of payroll calculations	N/A	✓	N/A
6) Payroll recorded on timely basis	N/A	✓	N/A
Initial Assessment of Control Risk	Moderate	Low	N/A
Test of Controls - W/P Ref.			
Final Assessment			

5	6	7	8	9	10
Assertions					
Valuation Allocation	Presentation/ Disclosure				
N/A	N/A				
✓	✓				
N/A	N/A				
N/A	N/A				
✓	✓				
✓	✓				
Moderate	Moderate				

AAM Section 5000

AUDIT APPROACH AND PROGRAMS

The material included in these sections on audit approach and programs is presented for illustrative purposes only. The comments, illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

This manual is a nonauthoritative kit of practice aids. Accordingly, these sections include minimal explanation and discussion of authoritative pronouncements. Users of this manual are urged to refer directly to applicable authoritative pronouncements when appropriate. Users should also note that this manual does not deal with specialized industry problems; reference should be made to applicable AICPA Audit and Accounting Guides.

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Section *Paragraph*

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AAM Section 5100
Designing the Audit Program

.01 The objective of an audit is to express an opinion on whether financial statements present fairly in all material respects, an entity's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. This conclusion may be expressed only when the auditor has formed such an opinion on the basis of an audit performed in accordance with generally accepted auditing standards. The procedures that the auditor plans to use to gather evidence are outlined in an audit program.

.02 Since the audit program describes the evidence-gathering steps to be used in the audit, it should be carefully designed. Designing an audit program involves three major considerations:

(1) Deciding *what* procedures to apply— the *nature* of audit tests

(2) Deciding *when* to apply the procedures—the *timing* of audit tests

(3) Deciding *which* items to apply the procedures to—the *extent* of audit tests

.03 Flowchart 1 presents an overview of the structure of the audit process. To design an audit program that is efficient and effective, the auditor should—

(1) Identify the client's assertions regarding each material component of the financial statements.

(2) Consider the risk of material misstatement.

(3) Establish specific audit objectives relating to the assertions in the financial statements.

(4) Determine the audit procedures to be performed to accomplish the audit objectives.

(5) Determine when to perform the audit procedures.

(6) Determine which of many items to apply audit procedures to.

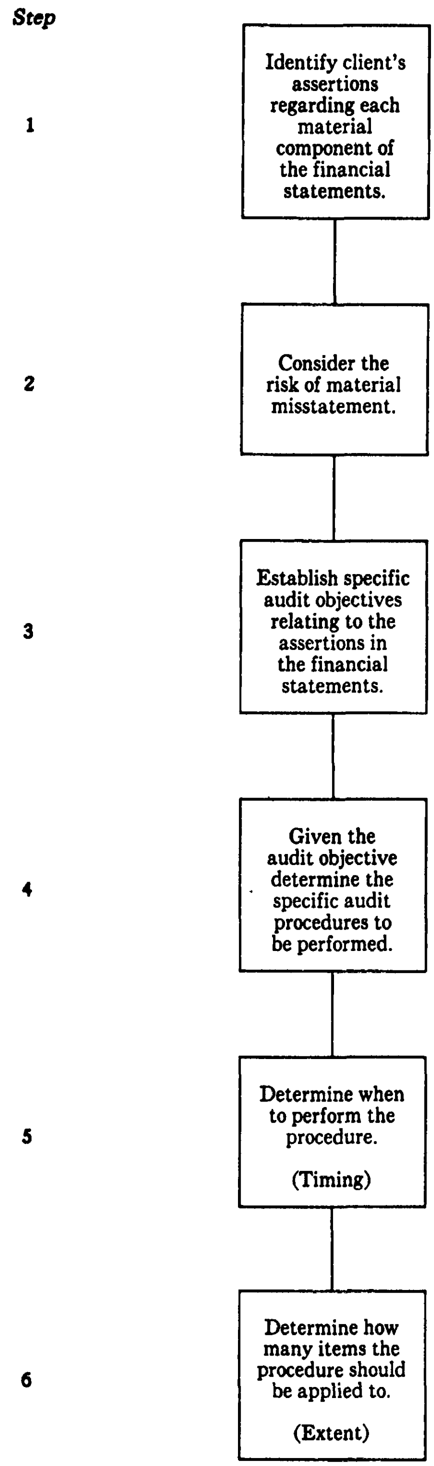
.04 The six steps illustrated in flowchart 1 result in a determination of the nature, timing, and extent of audit tests.

Financial Statement Assertions

.05 According to SAS No. 31, *Evidential Matter* (AU section 326), the independent auditor's work in forming an opinion on financial statements consists of obtaining and evaluating evidential matter concerning the assertions in such financial statements. These assertions are embodied in the account balance, transaction class, and disclosure components of financial statements and are classified according to the following broad categories:

Flowchart 1

Audit Logic Process



(1) *Existence or Occurrence.* Reported assets and liabilities actually exist at the balance sheet date, and transactions reported in the income statement actually occurred during the period covered.

(2) *Completeness.* All transactions and accounts that should be included in the financial statements are included, or there are no undisclosed assets, liabilities, or transactions.

(3) *Rights and Obligations.* The company owns and has clear title to assets and liabilities are obligations of the company.

(4) *Valuation or Allocation.* The assets and liabilities are valued properly, and the revenues and expenses are measured properly.

(5) *Presentation and Disclosure.* The assets, liabilities, revenues, and expenses are properly classified, described, and disclosed in the financial statements.

Developing Audit Objectives

.06 A misrepresentation of any of the five financial statement assertions could cause a material misstatement in the financial statements. The auditor should consider the risk of material misstatement for each assertion in the financial statements, and then obtain evidence to support the financial statement assertions to reduce the risk of material misstatement to an acceptably low level. To determine what type of evidence to obtain, the auditor develops specific audit objectives related to each assertion.

.07 In determining audit objectives, the auditor should evaluate each of the five assertions as they relate to the specific account balance or class of transactions being examined. For example, if the auditor is attempting to gather evidence on the assertion of *existence* of inventory, the auditor's objective would be to gather evidence that inventory included in the balance sheet physically existed at the date of the balance sheet.

Relationship of Assertions and Objectives for Inventory ***Figure 1***

Financial Statement Assertion	*Illustrative Audit Objectives*
Existence or occurrence	—Inventories included in the balance sheet physically exist.
Completeness	—Inventory quantities include all products, materials, and supplies on hand. —Inventory quantities include all products, materials, and supplies owned by the client that are in transit or stored at outside locations. —Inventory listings are accurately compiled and the totals are properly included in the inventory accounts.
Right and obligations	—The entity has legal title or similar rights of ownership to the inventory.
Valuation or allocation	—Inventories are properly stated at cost (except when market is lower).
Presentation and disclosure	—Inventories are properly classified in the balance sheet as current assets.

An example of the relationship between financial statement assertions and audit objectives for inventory is shown in figure 1.

Audit Tests

.08 After the auditor has determined the audit objectives, the method of achieving the objectives should be selected. Although these methods are referred to by various names such as audit procedures, audit techniques, and audit tests, they represent the evidence-gathering methods auditors use. The basic requirement for determining audit procedures, according to SAS No. 31, paragraph 12 (AU section 326.13), is that:

The procedures adopted should be adequate to achieve the audit objectives developed by the auditor, and the evidential matter obtained should be sufficient for the auditor to form conclusions concerning the validity of the individual assertions embodied in the components of financial statements.

.09 Some audit procedures can satisfy a combination of audit objectives for a given account balance or class of transactions. For example, the auditor's observation of a physical inventory count can provide evidence that inventories physically exist and that inventory quantities include all products, materials, and supplies on hand.

.10 Audit tests or procedures can be classified or categorized in a variety of ways. The most common classifications are by purpose of the test or by type of test.

Purpose of the Test

.11 According to SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AU section 319), the purpose of performing audit tests are:

a. To evaluate whether an internal control structure policy or procedure is operating effectively. These tests are referred to as tests of controls.

b. To detect material misstatements in financial statement assertions. These tests are referred to as substantive tests.

.12 The substantive test that the auditor performs consists of tests of details of transactions and balances and analytical procedures. In assessing control risk, the auditor also may use tests of details of transactions as tests of controls. The objective of tests of details of transactions performed as substantive tests is to detect material misstatements in the financial statements. The objective of tests of details of transactions as tests of controls is to evaluate whether an internal control structure policy or procedure operated effectively. Although these objectives are different, both may be accomplished concurrently through performance of a test of details on the same transaction.

.13 If the control risk is assessed at less than the maximum level, the auditor should obtain sufficient evidential matter to support that assessed level. The evidential matter that is sufficient to support a specific assessed level of control risk is a matter of auditor judgment. The type of evidential matter obtained all bear on the degree of assurance provided. Since the auditor's substantive testing is affected by the quality of the internal control structure policies and procedures, the auditor is concerned with whether the controls established are designed and operating effectively. The role of tests of controls is to justify this assertion.

.14 The most effective and efficient audit strategy for a small business engagement generally is to assess the control risk at the maximum level (the greatest probability that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by an entity's internal control structure). In this case, the auditor will use the knowledge obtained from the understanding of the internal control structure and the assessed level of control risk in designing substantive tests for financial statement assertions.

Type of Test

.15 Auditors perform four types of tests:

(1) Analytical procedures

(2) Inquiry and observation

(3) Tests of transactions

(4) Tests of balances

The relationship of audit tests by purpose to audit tests by type is shown in figure 2.

Analytical Procedures

.16 Analytical procedures are used for the following purposes:

a. To assist the auditor in planning the nature, timing, and extent of other auditing procedures.

b. As a substantive test to obtain evidential matter about particular assertions related to account balances or classes of transactions.

c. As an overall review of the financial information in the final review stage of the audit.

.17 Analytical procedures involve comparisons of recorded amounts, or ratios developed from recorded amounts, to expectations developed by the auditor. Analytical procedures are discussed in SAS No. 56, *Analytical Procedures* (AU section 329).

Inquiry and Observation

.18 Testing of internal control structure policies and procedures that leave no audit trail of documentary evidence is usually tested by inquiry and observation. Auditors make inquiries of different individuals and conduct observation tests to determine who performs a particular activity or how or when the activity is done. For example, the auditor may ask different individuals about who posts to the receivables ledger, the auditor may observe who prepares the bank reconciliation, or the auditor may observe when cash is deposited in the bank.

.19 Inquiry and observation can also be used as substantive tests. For example, an audit procedure such as observation of a *physical asset* to determine that it exists is a substantive test relating to the existence assertion. Likewise, inquiries regarding subsequent events would be a substantive test because they provide evidence regarding the adequacy of disclosures in the financial statements.

Matrix of Audit Tests by Purpose and Type ***Figure 2***

<table>
<tr><th colspan="2" rowspan="2"></th><th colspan="2">Purpose of Test</th></tr>
<tr><th>Substantive Test</th><th>Test of Controls</th></tr>
<tr><td rowspan="4">Type of Test</td><td>Analytical Procedures</td><td>Yes
Example A</td><td>No</td></tr>
<tr><td>Inquiry and Observation</td><td>Yes
Example H</td><td>Yes
Examples B, C</td></tr>
<tr><td>Tests of Transactions</td><td>Yes
Example D</td><td>Yes
Examples E, F</td></tr>
<tr><td>Tests of Balances</td><td>Yes
Examples G, H</td><td>No</td></tr>
</table>

Examples:

A—Comparison of this year's expenses with last year's expenses

B—Observation by auditor that cash is deposited daily by a specific clerk

C—Inquiry by auditor about who deposits cash and how often

D—Examination of invoices to support additions (specific transactions) to fixed assets account during year

E—Examine sales invoices to see if initials of credit manager are there to indicate a credit file and credit approval (Inspection Test)

F—Vouch from sales invoices to credit files to see if customer has a credit file and has been approved for credit (Reperformance Test)

G—Confirmation of year-end balances in accounts receivable

H—Observation of the existence of a building

Tests of Transactions

.20 Tests of transactions consist of the examination of the documents and accounting records involved in the processing of specific transactions. Such procedures can accomplish both testing of controls and substantive testing and are sometimes used concurrently.

.21 Tests of controls are accomplished when the auditor examines transaction documentation to determine if the internal control structure policies and procedures have been applied as prescribed. Tests of transactions as tests of controls can be classified as either inspection tests or reperformance tests. If the auditor examines documentation, the tests of controls are classified as an inspection test. Alternatively, if the auditor repeats an internal control structure policy and procedure performed by the client, the tests of controls are classified as reperformance tests. For example, an internal control structure policy and procedure may require employees to match vendors' invoices with purchase orders and receiving reports and then initial the invoices to indicate that the procedure was performed. If the auditor tests the control by examining invoices for initials, the test is an inspection test. If the auditor tests the control by comparing vendors' invoices with purchase orders and receiving reports, the test is a reperformance test. Regardless of whether the auditor tests by inspection or reperformance, the test of control is a test of transactions.

.22 The substantive objective of tests of transactions is accomplished when the auditor examines transaction documentation to determine if dollar errors exist in a balance. For example, if the auditor examines documentation supporting individual charges (debits) to an equipment account to determine that the account balance is fairly stated, the test is classified as a substantive test of transactions.

Tests of Balances

.23 Tests of balances consist of examination of evidential matter directly supporting the ending balance in an account. Tests of balances are substantive tests designed to identify misstatements by a direct test of the ending balance rather than by testing the transactions that make up that balance.

.24 Substantive tests of transactions and tests of balances are interrelated in that each class of transactions affects a related account balance. Since financial statement amounts are the accumulation of transactions, an auditor may test the transactions that enter the account (that is, the debits and credits), the account balance itself (that is, the ending balance), or both.

Linking Audit Procedures to Objectives

.25 To design an audit program, the auditor should select audit procedures that achieve specific audit objectives developed from the five broad assertions for each material account balance in the financial statements.

.26 In selecting audit procedures to achieve the audit objectives developed, an auditor considers the following, according to SAS No. 31:

(1) The risk of material misstatement of the financial statements including the assessed levels of control risk.

(2) The expected efficiency and effectiveness of possible audit procedures.

(3) The nature and materiality of the items being tested.

(4) The kinds and competence of available evidential matter.

(5) The nature of the audit objective to be achieved.

The Completeness Assertion

.27 SAS No. 31, paragraph 5 (AU section 326.05), discusses the completeness assertion:

> Assertions about completeness deal with whether all transactions and accounts that should be presented in the financial statements are so included. For example, management asserts that all purchases of goods and services are recorded and are included in the financial statements. Similarly, management asserts that notes payable in the balance sheet include all such obligations of the entity.

.28 Substantive tests that provide assurance regarding the completeness assertion are those that provide evidence about whether all transactions have been captured by the client's accounting system and are included in the financial statements.

.29 Gathering evidence about whether all transactions have been recorded is one of the most difficult audit objectives to achieve. Evidence of completeness can be even more difficult to obtain when a client does not have a good internal control structure or has only an informal record-keeping system. Because these two characteristics often apply to small business, satisfying the completeness objective can be difficult for the auditor in a small business engagement.

.30 Completeness relates to whether all items have been included in the financial statements. The completeness assertion is violated if a transaction or account is omitted from the financial statements. If a transaction is merely recorded in the wrong account, there is no violation of the completeness assertion since the transaction is still recorded in the financial statements. In such a situation, the accounts are not incorrect because of a completeness error; rather, they are incorrect because of a classification error. A classification error is a violation of the presentation and disclosure assertion.

.31 For many accounts, the completeness assertion is the most difficult to test. The difficulty arises because the auditor must gather evidence about potential unrecorded items. Sources of audit evidence regarding unrecorded items often are not readily available.

Lack of Evidence

.32 To give an unqualified opinion, the auditor must gather sufficient, competent evidential matter to reduce the level of audit risk to an appropriately low level. SAS No. 31, paragraph 22 (AU section 326.23), provides the following guidance when the auditor is unable to gather sufficient evidence to be satisfied regarding the completeness assertion:

> To the extent the auditor remains in substantial doubt about an assertion of material significance, he must refrain from forming an opinion until he has obtained sufficient competent evidential matter to remove such substantial doubt or he must express a qualified opinion or a disclaimer of opinion.

.33 SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities,* paragraph 8 (AU section 316.08), states:

> The auditor should exercise (a) due care in planning, performing and evaluating the results of audit procedures, and (b) the proper degree of professional skepticism to achieve reasonable assurance that material errors or irregularities will be detected. Since the auditor's opinion on the financial statements is based on the concept of reasonable assurance, the auditor is not an insurer and his report does not constitute a guarantee.

.34 SAS No. 31, requires the auditor to obtain evidence concerning inclusion in the financial statements of all types of transactions that the auditor has reason to believe has occurred based on the auditor's knowledge of the client and the industry in which it operates. The excerpt from SAS No. 53 (AU section 316), refers to transactions which the auditor has reason to believe have occurred. Utilizing professional skepticism while performing the audit, this would require the auditor to question transactions which are peculiar to the particular client or industry as well as questioning the lack of specific types of transactions.

.35 The results of a research study on audit problems encountered in small business engagements (Auditing Research Mongraph No. 5) indicates that many practitioners sometimes accept client representations as sufficient audit evidence when completeness of recorded transactions cannot be substantiated.[1] Client representations are part of the evidential matter the auditor gathers, but they should not be used as a substitute for the performance of those procedures considered necessary to form an opinion on the financial statements. An auditor cannot rely on client representations alone as sufficient audit evidence to substantiate the completeness of account balances and classes of transactions. When an auditor is unable to form an opinion, even though representations from the client have been received, there is a limitation on the scope of the audit that precludes the auditor from issuing an unqualified opinion (SAS No. 19, *Client Representations,* paragraph 12 [AU section 333.12]).

Internal Control Structure Policies and Procedures for Completeness

.36 Internal control structure policies and procedures for completeness include policies and procedures that are designed (1) to count or otherwise identify transactions executed by the entity and (2) to provide reasonable assurance that all transactions have been accurately recorded by the accounting system. For example, completeness controls over purchases can include reconciliation of all pre-numbered receiving reports (which would be required for all goods received) to recorded purchases and investigation of receiving reports that are missing, not recorded, or not otherwise accounted for. Many auditors prefer to rely on controls when gathering evidence of completeness since extensive substantive tests for completeness may be more difficult to design than those for other SAS No. 31 assertions.

.37 If the auditor desires to assess control risk at less than the maximum level, tests of controls should be performed to determine that the controls are working as prescribed to make that control risk assessment. Once the control risk is assessed at less than maximum, the auditor may restrict substantive procedures designed to obtain evidential matter regarding the completeness assertion. Taken alone, the assessed level of control risk, ordinarily, is not sufficiently low to eliminate the need to perform any substantive tests. In addition, small businesses often lack segregation of duties, which usually prevents the auditor from assessing control risk at a low level. As a result, it is necessary to perform substantive tests of the completeness assertion.

Substantive Tests

.38 Many substantive tests are of limited usefulness in detecting errors of omission because they are usually applied to recorded amounts. Unrecorded transactions are not included in the account balances or classes of transactions to which the auditor applies substantive tests.

.39 Of all the financial statement assertions, only completeness involves consideration of whether there are material amounts that are not included in the account balance or class of transactions being tested. Therefore, substantive tests of the completeness assertion differ somewhat from substantive tests of other financial statement assertions. The difference is highlighted by the following excerpt from SAS No. 31, paragraph 11 (AU section 326.11):

> In designing substantive tests to achieve an objective related to the assertion of existence or occurrence, the auditor selects from items contained in a financial statement amount and

[1] D.D. Raiborn, Auditing Research Monograph No. 5, *Audit Problems Encountered in Small Business Engagements* (New York: AICPA, 1982), p. 74.

searches for relevant evidential matter. On the other hand, in designing procedures to achieve an objective related to the assertion of completeness, the auditor selects from evidential matter indicating that an item should be included in the relevant financial statement amount and investigates whether that item is so included.

.40 Substantive tests can be designed to provide evidential matter to support a conclusion that specific account balances are not misstated by amounts that would cause the financial statements, taken as a whole, to be materially misstated because of unrecorded transactions.

.41 Important sources of evidential matter for completeness include source documents, such as order logs, shipping and receiving documents, and checks. One common test of completeness involves tracing amounts from source documents to amounts recorded in the accounting records. For example, the auditor may vouch selected cash disbursements after the end of the audit period to test the completeness of amounts recorded as accounts payable at the balance sheet date. Other substantive procedures that provide evidence concerning the completeness of financial statement account balances include the following:

(1) Sales-and-purchases cutoff procedures that include tracing shipping and receiving documents processed after the audit period to accounting records for the proper period.

(2) Analytical procedures in which the auditor investigates relationships among data that indicate a financial statement account or balance may be understated. For example, the auditor may obtain evidence that all interest-bearing debt is recorded by examining the relationship between recorded interest expense and the average balance of interest-bearing debt outstanding for the period. Disproportionate relationships based on the auditor's knowledge of interest rates should be investigated. Other examples include: a comparison of investment income to average investments for the period to test whether income earned on investments is recorded; the relationship of average pay times number of employees to payroll expense to substantiate that salaries are recorded; and the relationship of membership fee revenue to the number of members of an organization.

(3) Confirmations of balances or transactions designed to identify unrecorded amounts, such as accounts payable confirmations that request the creditor to specify the amount of the client's obligation.

(4) Tests of bank reconciliations, including examination of checks clearing the bank after the audit period to identify cash disbursements processed but not recorded or inappropriately recorded in the subsequent period.

(5) Reading the minutes of the meetings (of the) board of directors and stockholders and tracing transactions authorized in the minutes to amounts recorded in the accounting records.

(6) Overall reconciliations using financial and nonfinancial data, such as "proofs" of cash and sales.

[The next page is 5201.]

AAM Section 5200
Timing of Audit Tests

.01 During the planning stage of the audit, the auditor should consider *when* to apply audit tests. In a small business engagement, the auditor typically assesses control risk at the maximum level and does not perform tests of controls. As a result, the question of when to perform audit tests in small business engagements frequently applies only to substantive testing.

.02 The determination of whether substantive tests can or should be applied prior to year-end is usually based on practical considerations. In making that determination, the auditor evaluates the benefits of performing a substantive test prior to year-end against the potential costs of performing such interim work.

.03 For example, the auditor considers whether the benefits of easing pressures caused by a tight year-end reporting deadline outweigh the cost of gathering additional audit evidence necessitated by the use of a less effective test at an interim date.

.04 Substantive tests can be divided into two categories: those that can generally be applied at an interim date and those that *may be* efficient at an interim date only if certain conditions are met.

Substantive Tests That Can Generally Be Applied at an Interim Date

.05 Some substantive tests can generally be performed through any date prior to year-end and still be efficient and effective tests. Substantive tests that fall into this category are tests that apply to data readily available prior to year-end. Such tests include:

(1) Substantive tests of transactions to support balance sheet accounts (for example, supporting the details of additions and retirements to a fixed asset account)

(2) Substantive tests of transactions to support income statement accounts (for example, reviewing all charges over a certain dollar amount to the repairs-and-maintenance account)

(3) Analytical procedures that include calculations on an interim basis (for example, comparing actual and budgeted expenses for each month)

.06 In each of these tests, the auditor reviews information that is already available at an interim date. Even if these tests were done at year-end, the same information would be needed and the same procedure performed. Thus, these tests generally can be efficient when performed at an interim date.

.07 For example, auditors frequently support those balance sheet accounts with low activity, such as fixed assets, by analyzing the transactions within the account during the year. Consequently, for property, plant, and equipment the auditor can audit the account by analyzing material additions and retirements rather than by testing the ending balance. To support additions the auditor may vouch material additions to invoices. Vouching such invoices may be performed before year-end without reducing the efficiency or effectiveness of the test. At year-end, the auditor still may have to vouch invoices from the interim date to year-end. However, these invoices would have to be vouched regardless of whether the interim work was performed.

Conditional Substantive Tests

.08 Other substantive tests may be efficient when applied prior to year-end only if certain conditions are met. Generally, such substantive tests should only be applied prior to year-end if substantive tests for the remaining period from the interim date to year-end can be restricted.

.09 SAS No. 45, *Omnibus Statement on Auditing Standards,* describes several factors that should be considered before applying substantive tests to details of balance sheet accounts at interim dates. Those factors relate to the ability to control the additional risk of not detecting errors that may exist at the balance-sheet date when the balance is tested at an interim date. Factors described include:

(1) Whether the effectiveness of the tests will be impaired because of the auditor's assessment of the control risk

(2) Whether rapidly changing business conditions or circumstances might predispose management to misstate the financial statements between an interim date and year-end

(3) Whether the year-end balances of the particular balance sheet accounts are reasonably predictable with respect to amount, relative significance, and composition

.10 In many small business engagements, the cost of bringing the additional risk to an acceptably low level is too great. SAS No. 45 notes that "applying substantive tests ... at an interim date may not be cost-effective if substantive tests to cover the remaining period cannot be restricted due to the assessment of control risk." In the case of a small business with limited segregation of duties, these substantive tests are generally not performed at an interim date because to do so would be inefficient. For example, in a small business engagement, the auditor generally audits cash, accounts receivable, inventory, and accounts payable at year-end.

[The next page is 5301.]

AAM Section 5300
Extent of Testing

.01 Once an auditor decides what audit procedures to apply (the nature of the tests) and when to apply them (the timing of the tests), a decision must be made about how many items to apply the procedures to—that is, the extent of testing.

Authoritative Standards

.02 SAS No. 39, *Audit Sampling* (AU section 350), addresses a variety of issues relating to the auditor's use of sampling in an audit engagement. However, SAS No. 39 does not always apply when the auditor is examining less than 100 percent of a population. There has been some confusion in practice over when SAS No. 39 applies.

When SAS No. 39 Applies

.03 Audit sampling is only one of many tools used by auditors to obtain sufficient, competent evidential matter to support an opinion on financial statements. SAS No. 39 discusses design, selection, and evaluation considerations to be applied by the auditor when using audit sampling. As a general rule, audit sampling can be used—

(1) In tests of controls in the internal control structure to evaluate operating effectiveness from prescribed internal control structure policies and procedures.

(2) In substantive tests of details of account balances and classes of transactions.

(3) In dual-purpose tests that assess control risk and testing whether the monetary amount of a transaction is correct.

.04 The portion of SAS No. 39 pertaining to tests of control applies when sampling techniques are used to assess control risk. The portion pertaining to substantive tests apply when sampling techniques are used to test details of transactions or balances.

.05 SAS No. 39 defines audit sampling as "the application of an audit procedure to less than 100 percent of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of the balance or class." The key to understanding that definition is the *intent* of the auditor in applying the audit procedure. As noted in SAS No. 39, footnote 1, the auditor may examine less than 100 percent of the items in an account balance or in a class of transactions for reasons other than evaluating a characteristic of the balance or class. For example, the auditor would not be performing audit sampling in the following two situations:

(1) Tracing several sales transactions through a client's accounting system to gain an understanding of the manner in which transactions are processed. SAS No. 39 would not apply because the auditor's intent is to gain an understanding of the processing of these transactions by the accounting system, not to evaluate a characteristic of all sales transactions processed by the accounting system.

(2) Examining several large sales invoices that constitute a significant portion of the account balance and leaving the remaining portion of the balance untested or testing the remaining items by other means, such as the application of analytical procedures. Again, SAS No. 39 does not apply because the auditor is treating the account balance as two populations. For the large sales invoices, the auditor is not sampling since the population (all large sales invoices) is being examined. For the small sales invoices, the auditor is not sampling either because there is no examination of the items or because analytical procedures are performed.

.06 In determining whether SAS No. 39 is applicable to circumstances in which an auditor examines less than 100 percent of the items making up an account balance or class of transactions, the auditor should consider the purpose of the test. If the auditor intends to project the test results to the entire account balance or class of transactions for the purpose of evaluating a characteristic of the balance or class, the guidance in SAS No. 39 should be followed. For example, if the auditor intends to examine selected sales invoices to draw a conclusion about whether sales are overstated, audit sampling as described in SAS No. 39 should be applied because the auditor intends to draw a conclusion about all sales. On the other hand, if the auditor selects several large sales invoices for certain audit tests and then applies analytical procedures to the remaining invoices, the auditor is not sampling according to SAS No. 39—the examination of the large items is not intended to lead the auditor to a conclusion about the other items. In that case, any conclusion about whether sales are overstated would be based on the combined results of the test of large sales invoices, inquiry and observations, analytical procedures, and other auditing procedures performed related to overstatement of sales.

.07 The auditor should remember that the way in which the population is defined can determine whether the requirements of SAS No. 39 apply. The auditor might choose to divide a single reporting line on the financial statements into several populations. For example, accounts receivable might be divided into wholesale receivables, retail receivables, and employee receivables. Each of these populations can be tested using a different audit strategy—some using audit sampling and others not. The sampling concepts in SAS No. 39 apply only to populations for which audit sampling is used. Use of audit sampling on one population does not mandate its use on remaining populations.

Authoritative Guidance About the Application of Audit Sampling to Substantive Tests Provided by SAS No. 39

.08 There has been confusion in the accounting profession regarding what requirements are imposed by SAS No. 39. SAS No. 39 added the following seven specific provisions to professional standards.

(1) The concept that some items exist for which, in the auditor's judgment, acceptance of some sampling risk is not justified, and that these should be examined 100 percent (paragraph 21 [AU section 350.21]). This simply reminds the auditor that some of the items encountered in an examination of financial statements may be so significant individually or may have such a high likelihood of being in error or misstated that *all* such items should be examined.

(2) The suggestion that the efficiency of a sample may be improved by separating items subject to sampling into relatively homogeneous groups based on some characteristic (paragraph 22 [AU section 350.22]). This indicates that audit efficiency can sometimes be improved by, for example, stratifying or segregating the items constituting a balance or class of transactions into groups based on individual dollar value or some other characteristic.

(3) A requirement that the auditor consider tolerable misstatement in planning audit sampling applications in the examination of account balances and classes of transactions (paragraph 18 [AU section 350.18]). This asks the auditor to consider, in the early stages of an audit, how much misstatement the auditor will be able to tolerate for each balance and class of transactions that is sampled, in combination with misstatements in other accounts, and still render an unqualified opinion on the financial statements. SAS No. 39 asks the auditor to consider tolerable misstatement and to recognize that it is one of the factors influencing sample size. There is no requirement to document or quantify tolerable misstatement.

(4) A requirement that the auditor select a sample that can be expected to be representative of the population (paragraph 24 [AU section 350.24]). Simply put, this means that each item in the population being sampled should have *a chance* of being selected, not necessarily *an equal chance* of being selected. This does not mean that the auditor is required to use a random or probability sample.

(5) A requirement that the auditor consider selected sample items to which the auditor is unable to apply planned audit procedures to determine their effect on the evaluation of the sample (paragraph 25 [AU

section 350.25]). For example, sometimes the auditor may not be able to apply planned audit procedures to selected sample items because supporting documentation may be missing. If the auditor's evaluation of the sample results would not be altered by considering those unexamined items to be in error, it is not necessary to examine the items. However, if considering those unexamined items to be misstated would lead to a conclusion that the balance or class is materially in error, the auditor should consider alternative procedures that would provide sufficient evidence to form a conclusion.

(6) A requirement that the auditor project the misstatement results of the sample to the items from which the sample was selected (paragraph 26 [AU section 350.26]). Since the sample is expected to be representative of the population from which it was selected, misstatements found are also expected to be representative of the population. This merely asks the auditor to measure the likely misstatement in the population from which the sample was drawn and to consider it in reaching conclusions.

(7) A requirement that the auditor consider, in the aggregate, projected misstatement results for all audit sampling applications and all known misstatements from nonsampling applications when evaluating whether the financial statements taken as a whole may be materially misstated (paragraph 30 [AU section 350.30]).

Documentation Requirements in SAS No. 39

.09 SAS No. 39 contains no new or specific documentation requirements. However, the documentation standards set forth in the Statements on Auditing Standards dealing with documentation apply to audit sampling applications just as they apply to other auditing applications. For example, SAS No. 22, *Planning and Supervision* (AU section 311), states that the auditor should prepare a written audit program and SAS No. 41, *Working Papers* (AU section 339), requires the auditor to prepare working papers recording the work that the auditor has done and the conclusions that the auditor has reached concerning significant matters. Thus, with regard to audit sampling applications, the audit program might document such items as the objectives of the sampling application and the audit procedures related to those objectives. Documentation might also include the definition of the population and the sampling unit, including: (1) how the auditor considered completeness of the population, (2) the definition of misstatement, (3) the method of sample selection, (4) a list of misstatements identified in the sample, (5) an evaluation of the result of the sampling application, and (6) conclusions reached by the auditor.

Determining Extent of Testing in a Small Business Without Sampling

.10 Small businesses have certain characteristics that may influence the auditor's decision to use audit sampling. Because of the limited segregation of duties common in small businesses, auditors frequently choose to assess control risk at the maximum level, so generally the auditor of a small business will not have to consider tests of controls, including sampling of documentary evidence, to determine if controls are working as prescribed.

.11 For substantive testing, small businesses frequently have small populations of accounting data in both account balances and classes of transactions. Consequently, sampling may not be as useful since there may not be large populations of data.

.12 As noted previously, SAS No. 39, paragraph 1 (AU section 350.01), defines audit sampling: "The application of an audit procedure to less than 100 percent of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of the balance or class." This definition allows some alternative approaches to sampling to determine the extent of testing in a small business engagement. These alternatives, by not using audit sampling and thus eliminating the requirements of SAS No. 39, may provide a more effective and efficient audit approach for a small business engagement.

.13 These alternative approaches include:

(1) Procedures applied to 100 percent of a certain group (strata) of transactions or balances.

(2) Testing unusual items without applying procedures to the remainder of the population.

(3) Other tests that involve application of procedures to less than 100 percent of the items in the population without drawing a conclusion about the entire account or class of transactions.

.14 As previously noted, the auditor should decide what audit procedures to perform to meet the established audit objectives. Once this decision is made, the auditor needs to determine the extent of testing.

.15 An effective and efficient approach to determining the extent of testing in a small business engagement is shown in flowchart 1. This approach involves four important steps.

Identification of Individual Items to Be Examined

.16 An auditor should apply professional judgment in determining which individual items in an account balance or class of transactions need to be examined. In evaluating individual items, the auditor should consider factors such as size of the item, whether the item is unusual, prior experience with the client, and whether the item involves a related party.

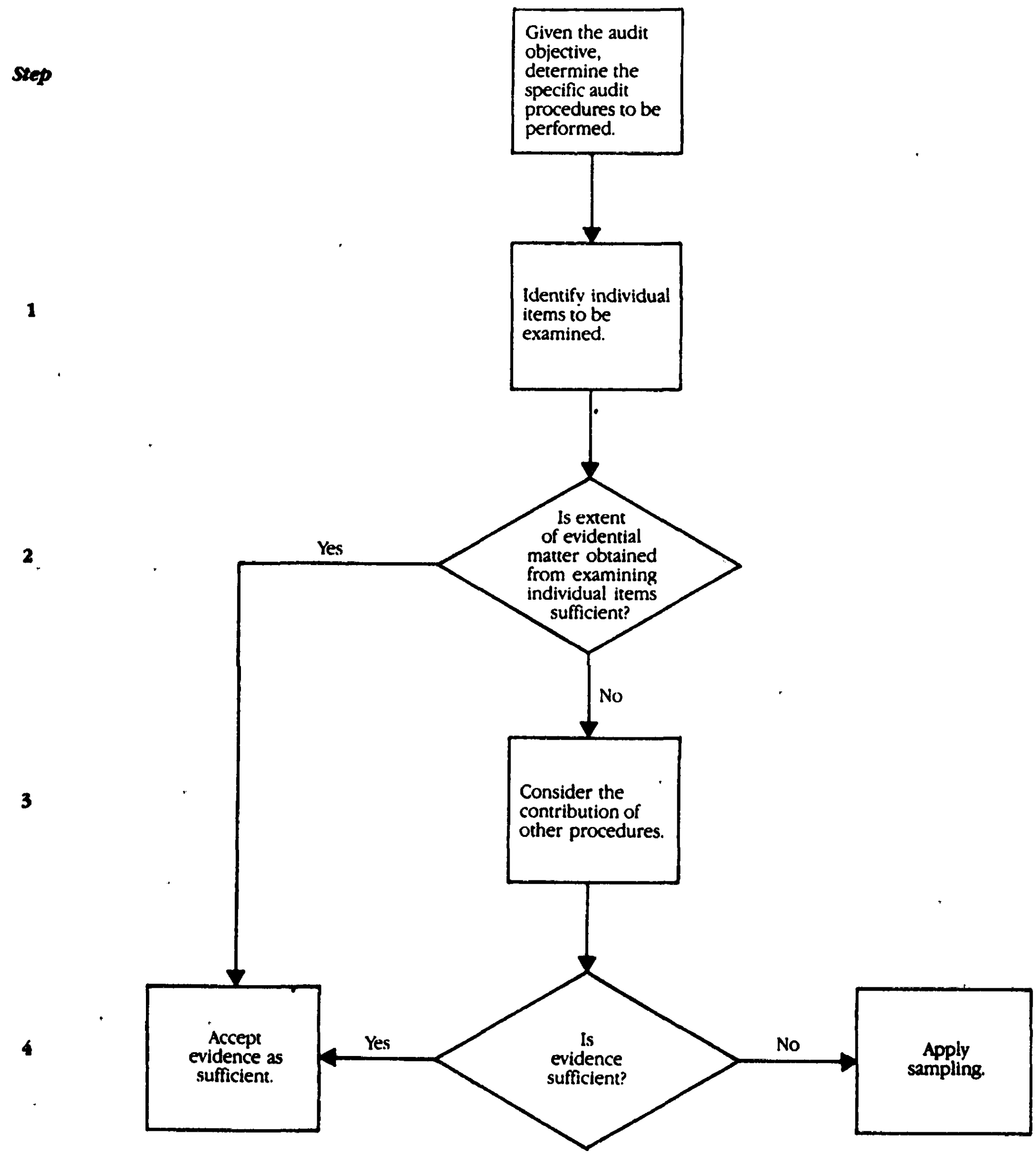
.17 For example, consider the following information for accounts receivable of a small business.

Number of Accounts	*Balances*	*Total Accounts*
4	$100,000 or more	$ 625,000
7	$25,000-99,999	375,000
62	$1-24,999	300,000
73		$1,300,000

In this case, if the eleven largest accounts are confirmed by the auditor, most of the accounts receivable balance is supported ($1,000,000 out of $1,300,000, or 77 percent). Also, the auditor may decide to confirm the receivables that have unusual characteristics (for example, receivables with either large credit balances or those that are very delinquent).

Flowchart 1

An Audit Sampling Approach for a Small Business



Is Extent of Evidential Matter Obtained Sufficient?

.18 Some factors which have been identified in SAS 39 in evaluating the sufficiency of evidential matter obtained in tests of details for a particular account balance or class of transactions are:

(1) The individual importance of the items examined. If the items examined, account for a high percentage of the total population, then the auditor may be reasonably assured that there is an acceptably low risk of an undetected misstatement.

(2) The nature and cause of misstatements. If during the course of the audit, misstatements are discovered, those misstatements should be evaluated to determine if they are due to differences in principle or in application, are errors or irregularities or are due to misunderstanding of instructions or carelessness.

(3) Possible relationship of the misstatement to other phases of the audit. If it is determined that the misstatement is an irregularity this would require a broader consideration of the possible implications than would the discovery of an error.

(4) The characteristics of the sample to the population. The auditor may obtain some knowledge of the types of items in the population if the characteristics in the sample are similar in nature and the same internal control structure policies and procedures are followed for processing the transactions.

.19 If an auditor has examined a substantial number of individual amounts and found no evidence of problems from the other procedures performed—and the remaining population totals less than an amount that would be material to the financial statements—there is often no need to sample the remaining population. Otherwise, the auditor should extend tests to the remaining population unless an alternative approach can be justified.

Consider Contribution of Other Procedures

.20 The auditor should also consider whether other evidence obtained contributes to conclusions regarding the account balance or class of transactions. The auditor often considers the contribution of other procedures at the same time the extent of evidential matter obtained from examining individual items is considered.

.21 The auditor may use a combination of analytical procedures and substantive tests of details to support an opinion on the financial statements. A small business audit does not typically include assessing control risk at less than the maximum level, so the auditor would rely primarily on analytical procedures and other substantive tests of details. In deciding whether other audit procedures make a contribution, the auditor should consider whether they support the audit objectives in the area, whether they indicate potential problems, and whether the evidence is consistent with the previous evidence obtained.

.22 In considering the contribution of other procedures, the auditor should use professional judgment in determining whether an unqualified opinion can be given without performing additional tests in the form of audit sampling.

Evaluation of Sufficiency of Evidence

.23 There are three factors that the auditor may consider in evaluating the sufficiency of audit evidence obtained from examining individual items and contributed by other procedures, and in determining whether the remaining items in the population should be tested.

.24 First, the auditor should consider whether the dollar amount of the remaining population is equal to or greater than an amount that would be material to the financial statements. If the remaining population is less than material, the auditor may decide that no additional testing by sampling is necessary. Second, the auditor should consider the degree of risk involved (that is, how susceptible the account is to misstatement, and whether there have been problems with this area in prior audits). Third, the auditor should consider the sufficiency of all the audit evidence obtained so far (the extent of evidential matter obtained by testing individual items along with the contribution of other procedures).

Planning the Extent of Testing Using Audit Sampling for Substantive Tests

.25 If the auditor decides to use audit sampling, the question becomes whether to sample statistically or nonstatistically. Regardless of the approach used, the auditor should—

(1) Use a selection method expected to be representative.

(2) Select a sample size that is adequate, giving consideration to materiality, audit risk, and population characteristics.

(3) Project misstatement based on sample results.

Selection of a Representative Sample

.26 SAS No. 39 merely requires that the sample be selected in such a way that it is expected to be representative of the population. There is no requirement in SAS No. 39 that random-sampling selection methods be used. Representative sampling methods used by auditors include *haphazard sampling, systematic sampling,* and *random sampling.*

.27 Haphazard sampling consists of selecting sampling units without any conscious bias—that is, without any special reason for including or omitting items from the sample. Haphazard sampling does not imply that units can be selected in a careless manner. Rather, a haphazard sample is selected in a manner that can be expected to be representative of the population. For example, if the physical representation of the population is a file cabinet drawer of vouchers, a haphazard sample of all vouchers processed for a year might include any of the vouchers that the auditor pulls from the drawer, regardless of each voucher's size, shape, location, or physical features. The auditor using haphazard selection should avoid distorting the sample by selecting, for example, only unusual or physically small items or by omitting items such as the first or last items in the population.

.28 In selecting a haphazard sample, the auditor may select the sample either with each item having an approximately equal chance of selection (neutral selection) or with the larger dollar-value items being emphasized (value-oriented selection). Both methods are appropriate haphazard-sample selection techniques meeting the requirement of SAS No. 39 that the sample be selected so that it is expected to be representative. In the case of neutral selection, the sample is expected to be representative of the *items* in the population. In the case of value-oriented selection, the sample is expected to be representative of the *dollars* in the population. Value-oriented selection using haphazard sampling is a general approximation of sample selection using probability-proportional-to-size sampling (dollar-unit sampling).

.29 Systematic sampling consists of determining a uniform interval and selecting throughout the population one item at each of the uniform intervals from the starting point.

.30 Random-number sampling entails matching random numbers generated by a computer or selected from a random-number table with, for example, document numbers.

.31 Another method that has been used in practice is block sampling. Block sampling consists of selecting groups of sequential items (for example, all vouchers processed on several selected dates). Using block samples is usually inefficient because, for a block sample to be adequate to lead to an audit conclusion, a relatively large number of blocks should be selected. In general, auditors should avoid using block sampling; however, if an auditor decides to use block sampling, special care should be exercised to control sampling risk in designing the sample.

.32 The AICPA Audit and Accounting Guide, *Audit Sampling*, contains a thorough description of these methods as well as other guidance on statistical and nonstatistical sampling methods.

Determining Sample Size

.33 There is no rule-of-thumb appropriate for the determination of a sample size in all applications. SAS No. 39 imposes no requirement to use quantitative aids, as sample size tables, to determine sample size—nor does SAS No. 39 impose a rule regarding minimum sample size. As before the issuance of SAS No. 39, professional judgment is the key. Auditors often use benchmarks or starting points, such as sample sizes used in prior years or in similar circumstances in other audit engagements, in determining what sample size is appropriate for a given sampling application. If the auditor uses a benchmark, the factors listed in SAS No. 39, paragraph 23 (AU section 350.23), that influence the auditor's judgment in determining sample size for substantive tests should be considered. Those factors include (1) tolerable misstatement, (2) the allowable risk of incorrect acceptance, and (3) the characteristics of the population (for example, the variability of the amounts of items in the population and the expected error in the population). An analysis of the factors that influence sample size for substantive testing is shown in figure 1.

.34 Individual firms or auditors often prefer to set their own rules regarding a benchmark or starting point for determining sample size. SAS No. 39 does not require such policies. It merely alerts the auditor to factors to be considered.

Projection of Error Based on Sample Results

.35 SAS No. 39 requires the auditor to project the results of the sample to the items in the population from which the sample was selected. There are several methods that satisfy the requirement of SAS No. 39 to project the sample error to the population. Two such methods are presented in the AICPA Audit and Accounting Guide, *Audit Sampling.*

(1) *Using ratio of population dollars to sample dollars*

$$\begin{array}{c}\text{Amount of sample}\\\text{misstatement}\end{array} \times \frac{\text{Population dollars}}{\text{Sample dollars}} = \begin{array}{c}\text{Projected population}\\\text{misstatement}\end{array}$$

If the auditor has identified \$1,000 of sample misstatements, sample dollars are \$10,000, and population dollars are \$100,000, the projected misstatement would be calculated as:

$$\$1{,}000 \times \frac{\$100{,}000}{\$10{,}000} = \$10{,}000 \text{ Projected population misstatement}$$

(2) *Using ratio of population items to sample items (rather than dollars)*

$$\begin{array}{c}\text{Sample}\\\text{misstatement}\end{array} \times \frac{\text{Population items}}{\text{Sample items}} = \begin{array}{c}\text{Projected population}\\\text{misstatement}\end{array}$$

If the auditor has identified \$1,000 of sample misstatements in examining 100 items out of 1,000 items in the population, the calculation in the example would be as follows:

$$\$1{,}000 \times \frac{1{,}000}{100} = \$10{,}000 \text{ Projected population misstatement}$$

Table 1

Factors Influencing Sample Sizes for a Substantive Test of Details in Sample Planning

Factor	*Conditions leading to Smaller sample size*	*Conditions leading to Larger sample size*	*Related factor for substantive sample planning*
a. Assessment of inherent risk.	Low assessed level of inherent risk.	High assessed level of inherent risk.	Allowable risk of incorrect acceptance.
b. Assessment of control risk.	Low assessed level of control risk.	High assessed level of control risk.	Allowable risk of incorrect acceptance.
c. Assessment of risk for other substantive tests related to the same assertion (including analytical procedures and other relevant substantive tests).	Low assessment of risk associated with other relevant substantive tests.	High assessment of risk associated with other relevant substantive tests.	Allowable risk of incorrect acceptance.
d. Measure of tolerable misstatement for a specific account.	Larger measure of tolerable misstatement.	Smaller measure of tolerable misstatement.	Tolerable misstatement.
e. Expected size and frequency of misstatements.	Smaller misstatements or lower frequency.	Larger misstatements or higher frequency.	Assessment of population characteristics.
f. Number of items in the population.	Virtually no effect on sample size unless population is very small.		

.36 These two methods produce the same result if the fraction represented by the proportion of population items to sample items is the same as the fraction represented by the proportion of population dollars to sample dollars. In practice, however, those fractions are usually not the same and the two methods do not usually produce the same result. If there is a significant difference in the two ratios, the auditor should consider whether there is reason to expect a relationship between misstatements and the size of the item. If the misstatement relates to the size of the item, the auditor should use the first method. If misstatements are relatively constant for all items, the auditor should select the second method. For example, assume the auditor is examining accounts receivable and notes that some receivables are incorrect. If the observed misstatements are unrelated to the size of the receivable, then the auditor should use the second method (Population Items to Sample Items). Alternatively, if the observed misstatements vary in size depending on the size of the receivable (that is, larger receivables have larger misstatements), the auditor should use the first method (Population Dollars to Sample Dollars).

.37 The auditor should calculate projected misstatement for each individual group or strata sampled. The projected misstatement for such groups should then be added to the actual misstatement found in the items that were examined 100 percent. The total is the projected misstatement for the account or class of transactions.

Statistical and Nonstatistical Sampling

.38 SAS No. 39 does not require that the auditor use either nonstatistical or statistical sampling. SAS No. 39 allows the auditor to use either method based on the auditor's professional judgment, factoring in the relative costs and benefits of each of the approaches.

.39 The Audit and Accounting Guide, *Audit Sampling,* demonstrates both statistical and nonstatistical sampling approaches to tests of controls and substantive testing.

[The next page is 5401.]

AAM Section 5400
Illustrative Audit Program for Corporations

.010 Some audit procedures (for example, tracing the bank balance per the bank reconciliation to the confirmation received from the bank) lend themselves to routine language. To draft this type of routine language for each engagement is time consuming. As a result, some auditors maintain lists of illustrative audit objectives and audit procedures as sources of routine language to save time when developing audit programs for specific engagements. Other auditors may refer to copies of programs from previous or similar engagements for the same purpose. In either case, the source of routine language is a mere manuscript aid subject to the auditor's professional judgment. The auditor's professional judgment must be applied in deciding whether the program includes all of the procedures required in the particular circumstances. The manuscript aid serves solely as a timesaver. Users of manuscript aids must remain alert to needs such as the following:

- Developing steps for required procedures which are not covered by the manuscript aid.
- Excluding extraneous and unnecessary procedures which are covered by the manuscript aid.
- Editing or modifying the manuscript to suit the needs and preferences of the auditor in the circumstances.

.020 Following is a list of illustrative audit objectives and procedures which are numbered merely to organize the materials; the numbers are not intended to imply completeness or a prescribed sequence. This list is merely illustrative. Some auditors may find the items too wordy, others may find them too terse, and still others may prefer a different set of items organized in a different manner. Users of this material must use professional judgment and be alert for the important matters in a particular set of circumstances which may not be covered in the illustrative material.

.021 The illustrative audit program permits the auditor to select audit procedures to be performed based on the assessed level of risk. If the auditor assesses control risk at the maximum level, it may be necessary to extend such tests to compensate for assessing control risk at that level. See AAM section 3165 for an illustrative audit planning checklist. This program can also be found in the Audit Program Generator (APG). APG is a computerized tool, published by the AICPA, which assists auditors in the preparation and tailoring of audit programs.

> The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

.030 I. General Procedures

Financial Statement Assertions:

1. Existence or occurrence.
2. Completeness.
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Procedures:

A. Planning

	Done By	Date	W/P Ref.
1. Has the illustrative planning checklist been completed? (See AAM section 3165)	____	____	____
2. Determine that decision to accept engagement (in case of new client) or to retain client has been documented. (See AAM section 11,500.08 and .09)	____	____	____
3. If this is a new client, ascertain that required communications with predecessor auditors, if any, have been made. (SAS No. 7 [AU section 315])	____	____	____
4. If other auditors are performing parts of the audit, ascertain that appropriate communications have been made?	____	____	____
5. Obtain an initial understanding of the client's operations:			
a. Review most recent management letter.	____	____	____
b. Obtain and review copies or abstracts of minutes of meetings of the Board of Directors, Shareholders, and/or relevant committees.	____	____	____
c. Obtain a list of all related parties.	____	____	____
6. Review correspondence files, prior year audit workpapers, permanent files, financial statements and auditor's reports. Also review any current year interim financial statements.	____	____	____
7. If client has internal audit staff, read reports and related correspondence, and consider possible effect of internal audit work and findings on scope of the examination. (SAS No. 65 [AU section 322])	____	____	____
8. Perform analytical procedures focusing on:			
a. Enhancing the auditor's understanding of the client's business and the transactions and events that have occurred since the last audit date.	____	____	____
b. Identifying areas that may represent specific risks relevant to the audit. (SAS No. 56 [AU section 329])	____	____	____
9. Discuss the type, scope and timing of audit with the owner/manager or board of directors or audit committee. Also discuss the adequacy of working space for the audit team, access to client records and assistance, if any, to be furnished by client.	____	____	____

	Done By	Date	W/P Ref.
10. Determine that a signed engagement letter covering the current engagement is on file. Read letter for any special provisions. List any special provisions and determine that the audit program addresses the provisions.	____	____	____
11. Prepare a preliminary time budget by audit area and determine the staffing assignments of audit personnel, as well as other auditors, consultants and/or specialists.	____	____	____
12. Discuss the audit plan with the engagement personnel. If considered necessary, prepare a planning memorandum for review by engagement staff.	____	____	____
13. Discuss the following (and other appropriate) matters with appropriate client personnel (including the audit committee of the company, if applicable).			
a. Changes in operations, including pending/planned changes.	____	____	____
b. Changes in accounting methods or accounting principles applied.	____	____	____
c. Changes in key personnel (accounting and data processing).	____	____	____
d. Significant accounting or reporting problems.	____	____	____
e. Principal findings of internal auditors, if applicable.	____	____	____
f. Changes in data processing methods or equipment.	____	____	____
g. Significant legal matters and contingencies.	____	____	____
h. Disposition of prior year's management letter points.	____	____	____
i. Extent of client assistance to be provided.	____	____	____
j. Timing of preliminary audit work, inventory observation, confirmation procedures, final audit work, etc.	____	____	____
k. Closing information to be prepared (check applicable items):			
(1) Closing Journal Entries	____	____	____
(2) Post Closing Trial Balance	____	____	____
(3) Audit Adjusting Entries	____	____	____
(4) Reversing Journal Entries	____	____	____
l. Other Matters (prepare list and attach to program).	____	____	____
14. Ascertain that notes regarding matters to be discussed with audit partner, manager and/or in-charge auditor have been prepared by staff members with specific concerns.	____	____	____
15. Obtain an understanding of the effect of laws, regulations, and ordinances having a direct and material effect on the financial statements, and prepare a list of such laws and regulations and attach to audit program.	____	____	____
16. Obtain an understanding of the client's internal control structure:			
a. Control environment—including such factors as:			
(1) Management philosophy and operating style			
(2) Entity's organizational structure			
(3) Functioning of the board of directors and its committees, particularly the audit committee			
(4) Methods of assigning authority and responsibility			
(5) Management's control methods for monitoring and following up on performance			
(6) Internal auditing			
(7) Personnel policies and practices			
(8) Various external influences that affect an entity's operations and practices, such as examinations by regulatory agencies	____	____	____
b. Accounting system in order to understand:			
(1) Classes of transactions in the entity's operations that are significant to the financial statements			

	Done By	Date	W/P Ref.
(2) How those transactions are initiated			
(3) The accounting records, supporting documents, computer media, and specific accounts in the financial statements involved in the processing and reporting of transactions			
(4) The accounting processing involved from the initiation of a transaction to its inclusion in the financial statements, including how the computer is used to process data			
(5) The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures	____	____	____
c. Control procedures to determine that the accounting system is working as described and that the control environment is effective:			
(1) Proper authorization of transactions and activities			
(2) Segregation of duties			
(3) Design and use of adequate documents to help insure the proper recording of transactions and events			
(4) Adequate safeguards over access to and use of assets and records			
(5) Independent checks on performance and proper valuation of recorded amounts	____	____	____
17. Use the understanding obtained of the internal control structure and consider factors influencing audit risk to evaluate the risk of material misstatements arising from errors, irregularities, and/or illegal acts, including the risk of management misrepresentation. Document conclusions in the working papers and their effects on engagement staffing, extent of supervision, and overall strategy for the conduct and scope of audit in the working papers.	____	____	____
18. Use the information obtained or developed concerning materiality levels, the internal control structure and the related assessments of control risk, the results of analytical procedures, and the evaluation of other factors impacting on audit risk to plan:			
a. The nature, timing, and extent of substantive tests;	____	____	____
b. Staffing requirements and related levels of supervision;	____	____	____
c. The overall strategy for the conduct and scope of audit. (This audit program is prepared based on financial statement captions. Dependent upon the client, it may be cost-effective to combine audit program sections, i.e., revenue and accounts receivable, payables and expenses, etc.)	____	____	____
19. Prepare listing of schedules/analyses to be prepared by client (and working paper set-ups, if considered necessary) and deliver to client.	____	____	____
20. Update the permanent file(s) for new agreements, copies or extracts of minutes and other important documents.	____	____	____
21. For trial balances and other schedules and analyses prepared by the client, document and perform the following:			
a. Trace amounts to the general ledger	____	____	____
b. Re-perform the footings and crossfootings (test basis may be appropriate)	____	____	____
c. Trace opening balances to final balances per the working papers for the preceding year (period).	____	____	____
d. Determine that working papers are marked "Prepared by Client" or "PBC."	____	____	____
22. Review journal and general ledger entries made during the period for propriety and accuracy.	____	____	____
23. Communicate with audit committee or other parties that have the responsibility for oversight of the financial reporting process, the following matters: (see SAS No. 61 [AU section 380])			

	Done By	Date	W/P Ref.
a. the auditor's responsibility under generally accepted auditing standards (i.e., matters relating to the internal control structure, whether the financial statements are free of material misstatement, etc.)			
b. significant accounting policies (i.e., initial selection of and changes in significant accounting policies, or their application)			
c. management judgments and accounting estimates (i.e., the process followed by management in formulating sensitive accounting estimates, the basis for the auditor's conclusions regarding the reasonableness of management's estimates)			
d. significant audit adjustments (whether recorded or not, it is a proposed correction of the financial statements, correction would not have been detected except through the auditing process)			
e. other information in documents containing audited financial statements (i.e., the auditor's responsibility for other information included with the audited financial statements)			
f. disagreements with managements (i.e., whether satisfactorily resolved or not, any matters that could be significant individually, or in the aggregate, to the entity's financial statements or the auditor's report)			
g. consultation with other accountants (i.e., any accounting or auditing matters which management had discussed with other accountants)			
h. major issues discussed with management prior to retention (i.e., issues relating to the application of accounting principles and auditing standards)			
i. difficulties encountered in performing the audit (i.e., unreasonable delays in commencement of the audit, providing information, client personnel, etc.)			
B. Conclusion of Audit			
1. Communicate internal control structure related matters noted (SAS No. 60 [AU section 325]).			
2. Obtain written representation from management of the client (SAS No. 19 [AU section 333]) and the company's legal representatives.			
3. Determine that required communications, proper as to form and content, have been made as necessary to disclose irregularities and/or illegal acts noted during the course of the audit.			
4. Perform the following analytical procedures:			
a. Reexamine the comparison of current-period amounts with amounts from prior periods, after correction of the amounts for any adjustments and reclassifications.			
b. Perform any additional analytical procedures, such as ratio analysis, that were not performed during the planning stage because preliminary amounts were unreliable.			
c. Identify significant or unexpected fluctuations and other unusual items.			
d. Based on the knowledge of the client's operations and the results of audit procedures, evaluate whether all significant or unexpected fluctuations have been adequately explained.			
e. Based on the results of the audit procedures performed, evaluate whether there is substantial doubt about the entity's ability to continue as a going concern:			
(1) Ascertain if any of the following negative trends exist:			
(a) Recurring operating losses			
(b) Working capital deficiencies			
(c) Negative cash flows from operations			
(d) Adverse key financial ratios			
(e) Calculate the Altman Z Score (the formula can be found in the AAM section 2300.16)			
(2) Ascertain if any of the following have occurred:			
(a) Default on loans or similar agreements			
(b) Arrearages in dividends			

	Done By	Date	W/P Ref.
(c) Denial of usual trade credit	____	____	____
(d) Restructuring of debt	____	____	____
(e) Noncompliance with statutory or contractual capital arrangements	____	____	____
(f) Need for new sources or methods of financing	____	____	____
(g) Need to dispose of substantial assets	____	____	____
(3) Ascertain if the following internal matters have occurred:			
(a) Work stoppages	____	____	____
(b) Other labor difficulties	____	____	____
(c) Substantial dependence on a particular project or customer	____	____	____
(d) Uneconomic long-term commitments	____	____	____
(e) Need to revise operations significantly	____	____	____
(4) Ascertain if the following external matters have occurred:			
(a) Legal proceedings	____	____	____
(b) Adverse legislation	____	____	____
(c) Loss of key franchise, license or plant	____	____	____
(d) Loss of principal customer or supplier	____	____	____
(e) Uninsured or underinsured catastrophe	____	____	____
5. Determine whether the audit work performed indicates that a substantial doubt exists with regard to the company's ability to continue as a going concern for a reasonable period of time. If a substantial doubt exists:			
a. Obtain information about management's plans, assess the expected effectiveness of the plans, and gather evidence to evaluate pertinent provisions of those plans and to support audit conclusions concerning the company's ability or inability to continue as a going concern.	____	____	____
b. Evaluate the adequacy of the related financial statement disclosures; and	____	____	____
c. Consider the effects on the audit report.	____	____	____
6. Read the financial statements and related notes and consider the following:			
a. the adequacy of the evidence gathered in response to unusual or unexpected balances identified in planning the audit or in the course of the audit	____	____	____
b. unusual or unexpected balances or relationships that were not previously identified (SAS No. 56 [AU section 329]).	____	____	____
7. Determine that all applicable disclosure checklists and review programs have been completed. (See Financial Statement Preparation Manual and AAM sections 9200-9500.)	____	____	____
8. Ascertain that all working papers have been headed, indexed, cross-referenced, initialed, and dated.	____	____	____
9. Accumulate all pending items in one listing, and dispose of all other follow-up or "TO DO" sheets and any other similar notations in the files.	____	____	____
10. Ascertain that all time has been posted to the daily time control records, and record totals on the engagement time summary. Write explanations for any significant variations between budgeted and actual time.			
NOTE: Many firms include other matters in the general section of programs, such as disposition of proposed adjustments, report preparation and review, reconciliation of actual and estimated time, preparation of fee estimate, evaluation of staff, etc.	____	____	____

	Done By	Date	W/P Ref.
C. Section Completion			
1. The objectives of this audit program have been met.	____	____	____

This audit program section has been completed in accordance with firm policy.

______________________________ Done by	____	____	____
______________________________ Reviewed by	____	____	____

The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

Done By | Date | W/P Ref.

.040 II. Internal Control Structure Policies and Procedures

Financial Statement Assertions:

1. Existence or occurrence.
2. Completeness.
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Procedures:

A. Revenues, Receivables, and Receipts—Audit Objectives

1. Obtain a sufficient understanding of the design of the relevant policies and procedures that relate to the revenues and receivables account balances and transactions and whether they have been placed in operation. (This will include sales, sales return, sales discounts, etc.) ____ ____ ____

B. Revenues, Receivables, and Receipts—Assessment of Risk

1. Document the understanding of internal control structure (the form and extent of documentation is influenced by the size, complexity, and nature of the internal control structure). (Review AAM section 4000 for sample internal control structure questionnaires.) ____ ____ ____
2. Assess the level of control risk.
   a. If the control risk is assessed at the maximum level, document this assessment (the basis for the assessment need not be documented) and go to step E. If the control risk is assessed at this level, the auditor will have to expand substantive tests to compensate for this level of control risk. Some examples of substantive tests which may be affected are shown in 3 below. ____ ____ ____
   b. If control risk is assessed at less than the maximum level, document the basis for this conclusion and obtain sufficient evidential matter to support this assessed level of control risk. Some examples of evidential matter which can be used to support this assessed level are shown in section C, below—Tests of Controls. ____ ____ ____
3. Based on the assessed level of control risk the timing and extent of substantive tests may be affected in, for example, the following aspects:
   a. The use of confirmations.
   b. If confirmations are used:
      (1) Extent and method of selection of accounts for confirmation.
      (2) Use of positive or negative forms of confirmation request, or a combination of both.
      (3) Timing of confirmation procedures.
      (4) Type of information needed on the confirmation request.
      (5) Anticipated scope of alternative procedures as to significant accounts which do not respond to confirmation requests.
   c. Nature and extent of tests to substantiate sales cut-off.
   d. Nature and extent of tests to substantiate deferral and realization of revenue in such situations as unearned subscription income or unearned finance charges on installment receivables.
   e. Approach to reviewing and evaluating adequacy of the allowance provided for doubtful accounts (review of allowances for specific accounts, comparison of experience relating to write-offs with sales and receivables, and the client's past and present credit policies and practices, etc.).

	Done By	Date	W/P Ref.

C. Revenues, Receivables, and Receipts—Tests of Controls

(Note: Tests of controls directed toward the operating effectiveness of an internal control structure policy or procedure are concerned with how the policy or procedure was applied, the consistency with which it was applied and by whom it was applied. The examples that follow assume that the client has policies and procedures in place which can be either inspected, observed or reperformed.)

1. Obtain the sales journal and for a selected period(s):
   a. Trace totals from the sales journal to the general ledger control accounts for revenues, receivables, and such other accounts as salesmen's commissions, provisions, and allowances for product warranties, etc. ____ ____ ____
   b. Trace selected individual items from the sales journal to such other subsidiary records as the salesmen's commissions detail, and entries to charge cost. ____ ____ ____
   c. Reconcile the sales journal to the entries to charge cost of sales and credit inventory. ____ ____ ____
   d. Test the arithmetic accuracy of the footings and crossfootings of the journals. ____ ____ ____
2. Obtain the cash receipts journal and perform the following on a test basis for a selected period(s):
   a. Trace totals to the general ledger for both the cash account and applicable account distributions such as accounts receivable, cash sales, investment income, and additions to notes payable (re: proceeds). ____ ____ ____
   b. Test the arithmetic accuracy of the footings and crossfootings of the cash receipts journal; reconcile total receipts to total deposits per the bank statement. ____ ____ ____
3. Select ... entries from the sales journal made at various times throughout the year, obtain the supporting documents, and perform the following tests:
   a. Compare the sales invoices with the entries in the sales journal for invoice date, invoice number, identity of customer, dollar amount, and any related items such as sales tax, salesmen's commissions, etc. ____ ____ ____
   b. Trace the sales invoice to the accounts receivable subsidiary (customers) ledger and to evidence of subsequent payment (remittance advice and cash receipts records). ____ ____ ____
   c. If the client charges cost of sales and credits inventory as items are sold, trace detail per the sales invoice to subsidiary records for cost of sales and inventory. ____ ____ ____
   d. Compare the sales invoice for customer identity, description of product, price, quantities, and amounts, to the applicable sales order, and customer's purchase order or job contract. Note evidence of approval of prices and credit as prescribed by management. ____ ____ ____
   e. Compare customer identity, description of product, and quantities per the sales invoice to the documents evidencing shipment; test computations of related freight and insurance charges. Ascertain whether sales are recorded in the proper months. ____ ____ ____
   f. Trace prices, discount, and payment terms to such sources as price lists, job quotations, and job contracts. ____ ____ ____
   g. Test arithmetic accuracy of extensions, footings, and computation of discounts. Note evidence of performance of a clerical check by client staff, where applicable. ____ ____ ____
4. Review the numerical sequence file of shipping orders for a selected period and account for missing numbers. ____ ____ ____
5. Select . . . shipping orders prepared at various times during the year. ____ ____ ____
   a. Obtain related sales invoices and trace them to the sales journal. ____ ____ ____
   b. Note whether billings are timely for shipments made. ____ ____ ____
6. Select . . . credit memorandums issued at various times during the year. ____ ____ ____

	Done By	Date	W/P Ref.
a. Ascertain whether credits were authorized in accordance with prescribed procedures.			
b. Review available supporting documentation.			
c. Trace the memorandums to the sales journal or other appropriate journal and to the accounts receivable subsidiary ledger.			
d. If the credit is granted for return of goods, inspect evidence of return and ascertain whether accounting for the returned goods is consistent with reported condition of the returned goods.			
7. From the cash receipts journal, select . . . cash receipts entered during the year; obtain the supporting remittance advices and perform the following:			
a. Compare the remittance advices with applicable entries per the cash receipts journal and trace to deposits per the bank statement(s). Ascertain the promptness of the deposit and recording of the entries.			
b. Trace detail posting of cash receipts to the accounts receivable, notes receivable, or other appropriate subsidiary ledgers. Ascertain whether cash receipts and related credits to accounts receivable are recorded consistently in the proper period.			
D. Revenue, Receivables, and Receipts—Evaluation of Tests of Controls			
1. Evaluate whether the assessed level of risk was appropriate based on the results of the tests of control and:			
a. Document matters considered and conclusions reached in making the control risk assessment in accordance with firm policy (completion of questionnaires, checklists, preparation of required memoranda, etc.).			
b. Based on the control risk assessment, make necessary modifications to applicable sections of the program for substantive tests.			
c. Identify and note reportable conditions in internal control structure to be brought to the client's attention (SAS No. 60 [AU section 325]).			
d. Identify and note other internal control structure matters to be brought to the client's attention.			
E. Purchases, Accounts Payable, and Disbursements—Audit Objectives			
1. Obtain a sufficient understanding of the design of relevant policies and procedures which relate to classification of costs or expenses and charges to accounts such as property and equipment and prepaid expenses and whether they have been placed in operation.			
F. Purchases, Accounts Payable, and Disbursements—Assessment of Risk			
1. Document the understanding of the internal control structure (the form and extent of documentation is influenced by the size and complexity and nature of the internal control structure). (Review AAM section 4000 for sample internal control structure questionnaires.)			
2. Assess the level of control risk.			
a. If the assessment of control risk is at the maximum level, document this assessment (the basis for the assessment need not be documented) and go to step I. If the control risk is assessed at this level, the auditor will have to expand substantive tests to compensate for this level of control risk. Some examples of substantive tests which may be affected are shown in 3 below.			
b. If control risk is assessed at less than the maximum level, document the basis for this conclusion and obtain sufficient evidential matter to support this assessed level of control risk. Some examples of evidential matter which can be used to support this assessed level are shown in section G below—Tests of Controls.			
3. Based on the assessed level of control risk the timing and extent of substantive tests may be affected in, for example, the following aspects:			

	Done By	Date	W/P Ref.

a. Extent of analytical procedures and tests of details of transactions and balances regarding classification of costs or expenses and charges to accounts such as property and equipment and prepaid expenses.

b. Extent of testing of details of transactions and balances to substantiate recorded payables and search for unrecorded liabilities as of the balance sheet date.

c. Need for and extent of confirmation of payables from vendors.

d. The number of days following the balance sheet date for which cut-off bank statements should be obtained.

e. The extent to which (if any) tests of cash balances can be performed at interim dates.

f. The extent to which testing of outstanding checks, deposits in transit, and other reconciling items can be restricted.

g. The number of days before and after the balance sheet date which should be used for the testing of bank transfers.

h. Whether all bank transfers during the selected period or only those over a selected dollar amount should be tested.

i. Whether petty cash funds should be counted or confirmed with the custodian as of the balance sheet date.

j. Whether petty cash funds should be counted on a surprise basis.

k. The need for coordination of cash counts with inspection of marketable securities and other investments.

G. Purchases, Accounts Payable, and Disbursements—Tests of Control

(Note: Tests of controls directed toward the operating effectiveness of an internal control structure policy or procedure are concerned with how the policy or procedure was applied, the consistency with which it was applied and by whom it was applied. The examples that follow assume that the client has policies and procedures in place which can be either inspected, observed or reperformed.)

1. Obtain the voucher register and for a selected period(s):

   a. Trace postings to other subsidiary registers, if used (for example, property tax register). ____ ____ ____

   b. Test the arithmetic accuracy of the footings and crossfootings of the voucher register for a test period(s). ____ ____ ____

   c. Trace totals to the general ledger for both accounts (vouchers) payable and the various account distributions. ____ ____ ____

2. Select . . . entries from the voucher register for various months throughout the year, obtain supporting documents and perform the following tests:

   a. Compare the entry in the voucher register to the vendor's invoice as to date, payee, description, and amount and test the clerical accuracy of the invoice. ____ ____ ____

   b. Determine that the invoice is supported by (i) an approved purchase order or payment request form and, if applicable, a properly executed purchase requisition and (ii) a signed receiving report or other evidence of receipt of services or goods, or otherwise authorized in accordance with prescribed procedures. ____ ____ ____

   c. Determine that the account distribution in the voucher register is reasonable and in agreement with the purchase order. ____ ____ ____

   d. Determine that purchase discounts have been properly recorded. ____ ____ ____

   e. Determine that freight has been billed in conformity with the purchase order. ____ ____ ____

   f. Examine the cancelled check issued to payment of the invoice for date, payee, amount, signature, and endorsement. Trace to cash disbursements journal. ____ ____ ____

   g. Inspect the voucher for evidence of clerical check, approval of payment as prescribed by management, and appropriate cancellation. ____ ____ ____

	Done By	Date	W/P Ref.
3. Review the numerical sequence files of receiving reports and of purchase orders and determine whether missing numbers are accounted for. (Failure by the client to do so increases the risk that unrecorded liabilities may exist.)			
4. Obtain the cash disbursements journal and perform the following on a test basis:			
a. Trace postings for a selected period(s) to the general ledger for both the cash accounts and applicable account distributions.			
b. Trace postings for a selected period(s) to other applicable subsidiary records, if present (for example, voucher or purchase journal, insurance and property tax registers, plant ledger, etc.).			
c. For a selected period(s), foot and crossfoot the cash disbursements journal; reconcile total disbursements to the bank statement.			
5. Review the numerical sequence of checks issued for a selected period and account for missing numbers as void or included on the list of outstanding checks. Select .... checks drawn at various times during the year from the disbursements journal and obtain the paid checks and supporting detail for the disbursements:			
a. Examine the paid checks and trace identity of signatures to the list of authorized check signers. (Consider requesting confirmations from banks of authorized check signers.)			
b. Compare identity of payee to endorsement; review checks for unusual endorsements and schedule those found for further investigation.			
c. Compare paid check and supporting detail to the cash disbursements journal for check number, date drawn, payee, amount, and account distribution.			
6. Review the client's bank reconciliations; for a selected period(s) perform the following tests of the bank reconciliation(s) and related listings of outstanding checks:			
a. Prove the arithmetic accuracy of the bank reconciliation, including the list of outstanding checks.			
b. Trace the bank balance to the bank statement and the book balance to the general ledger account.			
c. Trace the paid checks accompanying the bank statement to the cash disbursements journal and outstanding check list for the preceding month-end.			
d. Trace deposits per the bank statement to the cash receipts journal and deposits in transit per bank reconciliations of the preceding month-end.			
e. Trace deposits in transit to the bank statement for the following month; note whether the time interval between the dates per book and bank appear reasonable.			
f. Trace outstanding checks to paid checks which accompany the bank statement for the month(s) subsequent to the reconciliation tested; compare paid checks to the cash disbursements journal and inspect signature(s) and endorsements.			
g. Trace other reconciling items to supporting documents and check subsequent disposition.			
7. Consider preparing a proof of cash for a test period including the tests described in step 6 above and the following:			
a. Trace totals per the cash receipts and disbursements journals to the general ledger cash accounts; identify and obtain explanations for significant and unusual cash entries in the general ledger during the test period. Foot the receipts and disbursements journals and prove the arithmetic between the opening and closing general ledger cash balances for the test period.			
b. Prove the arithmetic accuracy of the bank statement by footing the deposits and disbursements, adding the opening balance and deducting the closing balance and ascertaining that the resulting differences equal total disbursements.			

	Done By	Date	W/P Ref.
c. Account for all deposits per books as deposits per bank or deposits in transit. Determine that deposits are made on a timely basis.			
d. Review the numerical sequence of checks issued during the period, accounting for them as paid during the period, included on the list of outstanding checks, or void. Determine that void checks have been properly mutilated.			
e. Note: The working paper format for this step would present reconciliations of total receipts and disbursements per the cash books to the respective total credits and charges per the bank statement(s) in addition to reconciliations of the bank and book balances at the beginning and end of the selected period. This working paper format may be used to reconcile total activity per the cash books and bank statements for various time periods such as a month or several months.			
8. Select the paid check(s) to reimburse the petty cash fund(s) from the cash disbursements journal; examine the voucher and paid check for consistency with the disbursement journal and prescribed approval and account distribution, and perform the following tests:			
a. Foot supporting evidence by account distribution and trace total to reimbursement voucher.			
b. Trace reimbursement voucher to cash disbursements journal and petty cash book.			
c. Examine petty cash vouchers for the following:			
(1) Prepared in ink			
(2) Approved			
(3) Cancelled after reimbursement			
(4) Dated			
(5) Payee			
(6) Amount			
(7) Signature			
(8) Account charged			
(9) Numbered consecutively			
(10) Reasonableness of amount and business purpose			
H. Purchases, Accounts Payable, and Disbursements—Evaluation of Tests of Controls			
1. Evaluate whether the assessed level of risk was appropriate based on the results of the tests of control and:			
a. Document matters considered and conclusions reached in making the control risk assessment in accordance with firm policy (completion of questionnaires, checklists, preparation of required memoranda, etc.).			
b. Based on the control risk assessment, make necessary modifications to applicable sections of the program for substantive tests.			
c. Identify and note reportable conditions in internal control structure to be brought to the client's attention (SAS No. 55 [AU section 319]).			
d. Identify and note other internal control structure matters to be brought to the client's attention.			
I. Payroll—Audit Objectives			
1. Obtain a sufficient understanding of the design of relevant policies and procedures which relate to the payroll account balances and transactions and whether they have been placed in operation.			
J. Payroll—Assessment of Risk			

	Done By	Date	W/P Ref.
1. Document the understanding of the internal control structure (the form and extent of documentation is influenced by the size and complexity and nature of the internal control structure). (Review AAM section 4000 for sample internal control structure questionnaires.)	____	____	____
2. Assess the level of control risk.			
a. If control risk is assessed at the maximum level, document this conclusion (the basis for the conclusion need not be documented). If the control risk is assessed at this level the auditor will have to expand substantive tests to compensate for this level of risk. Some examples of substantive tests which may be affected are shown in 3 below.	____	____	____
b. If control risk is assessed at less than the maximum level, document the basis for this conclusion and obtain sufficient evidential matter to support this assessed level. Some examples of evidential matter which can be used to support this assessed level are shown in Section K—Tests of Controls.	____	____	____
3. Based on the assessed level of control risk the timing and extent of substantive tests may be affected in, for example, the following aspects:			
a. The extent to which analytical procedures are applied to payroll costs and expenses and the extent to which fluctuations are investigated.			
b. Whether, and to what extent, gross pay is reconciled to individual earnings records.			
c. Whether, and to what extent, a payoff is made.			
d. The extent to which labor charges to property and equipment and to inventory are tested.			
e. The extent to which payroll taxes withheld and accrued are tested.			

K. Payroll—Tests of Controls

(Note: Tests of controls directed toward the operating effectiveness of an internal control structure policy or procedure are concerned with how the policy or procedure was applied, the consistency with which it was applied and by whom it was applied. The examples that follow assume that the client had policies or procedures in place which can be either inspected, observed or reperformed.)

	Done By	Date	W/P Ref.
1. Obtain the payroll register for a selected period(s):			
a. Trace totals per the register through applicable payroll summaries to the paid check used to transfer cash for net pay to the payroll bank account, and to postings in the general ledger (and cost accounting records, if applicable) for wage and salary cost and expense distributions, and liabilities for payroll withheld and deducted.	____	____	____
b. Trace payroll withheld through applicable subsidiary records to the payroll tax returns. Review the payroll tax returns; examine the check remitting withholdings to the governments (federal and state) and trace to the general ledger liability accounts.	____	____	____
c. Determine whether payroll was approved in accordance with prescribed procedures. (For example, approval might be a signature on a payroll summary and request for the deposit of net pay to the payroll bank account; the signature on the check used to transfer money to the payroll bank account; approvals directly on the registers; etc.)	____	____	____
d. Test the arithmetical accuracy of the footings and crossfootings of the payroll register.	____	____	____
2. Select . . . entries from the payroll register made at various times throughout the year, and perform the following procedures:			
a. Examine authorization for rate of pay and evidence in support of payment (for example, time records, piece-work production reports or other documentation which has been approved as prescribed by management) and on a test basis recompute gross pay.	____	____	____

	Done By	Date	W/P Ref.
b. Examine proper authorizations for payroll withholdings such as signed W-4 forms and on a test basis recompute amounts withheld.	____	____	____
c. Test arithmetical accuracy of net pay based on gross pay less deductions.	____	____	____
d. Examine cancelled checks noting date, check number, name of payee and comparing net pay to the payroll register, signature to list of authorized check signers, and endorsement to the signed W-4 forms.	____	____	____
e. Examine signed receipt for employees paid by cash, compare amount on the receipt with the payroll register and compare signature to the signed W-4 form.	____	____	____
f. Compare the individual payroll entry on the payroll register to the records used to accumulate year-to-date employee compensation for such purposes as preparation of payroll tax returns and W-2 forms.	____	____	____
3. Authorization of rate of pay. (For example, memoranda in the personnel files evidencing approval as prescribed by management, union contracts, approved rate or salary schedules, authorization of officer's salaries per minutes of board of director's meetings.)	____	____	____
4. Evidence in support of payment. For example:			
a. Time cards or records, which have been approved as prescribed, for employees paid on an hourly basis and for employees paid for overtime.	____	____	____
b. Production reports, which have been approved as prescribed, for employees paid on a piece-work basis.	____	____	____
c. Sales and commission registers, and evidence that advance drawings for commission salesmen had been approved as prescribed.	____	____	____
5. Evidence in support of payroll withholdings. (For example, signed W-4 forms or other proper authorization.)	____	____	____
6. Evidence of review of payroll for clerical accuracy, reasonableness, and account distribution, as prescribed by management.	____	____	____
7. Evidence of individual payroll records. (For example, the individual payroll entry to the records used to accumulate year to date employee compensation for such purposes as preparation of payroll, tax returns and W-2 forms.)	____	____	____
8. Consider, based on the preliminary evaluation, whether to:			
a. Observe the distribution of payroll checks or cash, including control of unclaimed wages.	____	____	____
b. Physically observe selected employees in the performance of their duties.	____	____	____
L. Payroll—Evaluation of Tests of Controls			
1. Evaluate whether the assessed level of risk was appropriate based on the results of the tests of control and:			
a. Document matters considered and conclusions reached in making the control risk assessment in accordance with firm policy (completion of questionnaires, checklists, preparation of required memoranda, etc.).	____	____	____
b. Based on the control risk assessment, propose necessary modifications to applicable sections of the program for substantive tests.	____	____	____
c. Identify and note reportable conditions in internal control structure to be brought to the client's attention (SAS No. 55 [AU section 319]).	____	____	____
d. Identify and note other internal control structure matters to be brought to the client's attention.	____	____	____

M. Inventories and Cost of Sales—Audit Objectives

1. The auditor must obtain a sufficient understanding of the design of relevant policies and procedures which relate to the inventory costs of sales account balances and transactions and whether they have been placed in operation.

N. Inventories and Cost of Sales—Assessment of Risk

	Done By	Date	W/P Ref.
1. Document the understanding of the Internal Control Structure (the form and extent of documentation is influenced by the size, complexity, and nature of the internal control structure). (Review AAM section 4000 for sample internal control structure questionnaires.)			
2. Assess the level of control risk.			
a. If control risk is assessed at the maximum level, document this conclusion (the basis for the conclusion need not be documented). If the control risk is assessed at this level the auditor will have to expand substantive tests to compensate for this level of risk. Some examples of the substantive tests which may be affected are shown in 3 below.			
b. If control risk is assessed at less than the maximum level, document the basis for this conclusion and obtain sufficient evidential matter to support this assessed level. Some examples of evidential matter which can be used to support this assessed level are shown in section O—Tests of Controls.			

3. Based on the assessed level of control risk the timing and extent of substantive tests may be affected in, for example, the following aspects:
   a. The extent to which physical inventories are observed and/or perpetual records tested.
   b. Whether physical inventories are taken at a preliminary date or at the balance sheet date.
   c. The extent to which consigned inventories are confirmed.
   d. The extent to which inventory prices are tested to supporting documentation.
   e. The extent to which analytical procedures are applied to cost of sales and the extent to which fluctuations are investigated.
   f. The extent to which cutoffs are tested.
   g. The extent to which inventories are tested for obsolete or excess stock.

O. Inventories and Cost of Sales—Tests of Controls

(Note: Tests of controls directed toward the operating effectiveness of an internal control structure policy or procedure are concerned with how the policy or procedure was applied, the consistency with which it was applied and by whom it was applied. The examples that follow assume that the client has policies and procedures in place which can be either inspected, observed or reperformed.)

	Done By	Date	W/P Ref.
1. Tour the client's manufacturing or production facilities with a member of the client's organization familiar with production.			
2. Select a sample of transactions for additions and deletions of inventory from such sources as receiving reports, requisitions to place materials into production, and shipping documents. Note the reference or control number, date, description, quantity and dollar amount for each transaction selected. Trace the transactions to the perpetual inventory record and the cost accounting records, if any, used to determine unit or job costs. Perform similar tests selecting the transactions from the perpetual inventory records and/or cost accounting records and trace the transactions to receiving reports, requisitions and shipping documents. Note: This testing may be coordinated with tests of controls for purchases, payables, and disbursements, and for revenues, receivables, and receipts.			
3. Obtain an analysis of overhead costs charged to inventories and over- or under-absorbed overhead. Review the amounts included in the overhead pool for propriety and perform the following:			
a. Determine that overhead costs are being charged to inventory in accordance with an appropriate policy (for example, as a percent of direct labor).			
b. Identify disposition of variances, if any, between actual overhead costs incurred and overhead costs applied to production and inventory. Determine that variances are reasonable. Determine that no excessive costs for idle plant are being charged to inventory.			

	Done By	Date	W/P Ref.
4. If a job order cost system is used, obtain the job order ledger (or tabulation), select a period(s) and perform the following:			
a. Trace total costs incurred to the voucher register (or cash disbursements journal), the payroll distribution, and support for overhead applied.	____	____	____
b. Test the footings of the job order ledger by refooting the detail for selected subtotals and refooting the subtotals.	____	____	____
c. Select . . . job orders for jobs in process and completed jobs and perform the following:			
(1) Examine authorization for the job order.	____	____	____
(2) Trace materials used on a test basis at various times since inception of the job order to such supporting details are requisitions, purchase orders, receiving reports, and processed invoices. (Consider coordination with compliance tests for purchases.)	____	____	____
(3) Trace direct labor costs to account distributions of the payroll registers and on a test basis to individual time reports or time cards. (Consider coordination with tests of controls for payroll.)	____	____	____
(4) Trace application of overhead costs to analyses used to accumulate overhead costs; test computations and review for reasonableness.	____	____	____
(5) Identify the status of the job (work in process, finished goods, or goods shipped) and trace through necessary summarization to the applicable general ledger account. Obtain explanation for any unreasonable time lag between completion and shipping dates for job orders performed for specific customers.	____	____	____
5. For process cost systems, obtain the cost of production reports for each department within the production process for a selected period(s) and:			
a. Trace quantities and dollar amounts for units received for selected departments to the quantities and dollar amounts transferred out per the preceding department in the sequence of production.	____	____	____
b. For each selected department, review the computations of total and unit costs for production transferred to the next department; on a test basis recompute unit costs and ascertain that costs for units lost in process are properly reallocated to surviving units.	____	____	____
c. Trace materials costs charged to the selected departments to appropriate journals and on a test basis to individual requisitions.	____	____	____
d. Trace labor costs incurred to account distribution analyses of the payroll registers.	____	____	____
e. Review the allocation of overhead.	____	____	____
P. Inventories and Cost of Sales—Evaluation of Tests of Controls			
1. Evaluate whether the assessed level of risk was appropriate based on the results of the tests of controls and:			
a. Document matters considered and conclusions reached in making the control risk assessment in accordance with firm policy (completion of questionnaires, checklists, preparation of required memoranda, etc.).	____	____	____
b. Based on the control risk assessment, make necessary modifications to applicable sections of the program for substantive tests.	____	____	____
c. Identify and note reportable conditions in internal control structure to be brought to the client's attention (SAS No. 55 [AU section 319]).	____	____	____
d. Identify and note other internal control structure matters to be brought to the client's attention.	____	____	____

	Done By	Date	W/P Ref.
Q. Section Completion			
This audit program section has been completed in accordance with firm policy.			
Done by			
Reviewed by			

The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

Obj.		Done By	Date	W/P Ref.

.050 III. Cash

Financial Statement Assertions:

1. Existence or occurrence.
2. Completeness.
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Objectives:

A. Existence of cash—to determine that cash exists and is owned by the entity. (Assertions 1 and 3)

B. Proper cut-off—To determine that cash balances reflect a proper cut-off of cash receipts and disbursements. (Assertions 1, 2 and 4)

C. Cash complete—To determine that cash balances as presented in the balance sheet properly reflect all cash and cash items on hand, in transit, or on deposit with third parties. (Assertions 1, 2 and 5)

D. Proper classification—To determine that cash balances are properly classified in the financial statements and any restrictions on the availability of funds are properly disclosed. (Assertions 3 and 5)

NOTE: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Procedures:

A. Cash in Banks—Substantive Test Procedures

Obj.	Procedure	Done By	Date	W/P Ref.
A C D	1. Confirm bank balances (using standard forms to confirm account balance information with financial institutions) as of the balance sheet date for all banks used during the year.	____	____	____
B [C]	2. Arrange to obtain cut-off bank statements and related paid checks directly from the banks for . . . days following the balance sheet date.	____	____	____
C	3. Obtain or prepare a comparative listing of the component bank account(s) and petty cash fund balances as of the closing and opening balance sheet dates for the year (period) being audited:	____	____	____
	a. Refoot the schedule and trace totals to the financial statement assembly sheets.	____	____	____
	b. Trace closing balances to the general ledger and working papers on bank reconciliations and petty cash funds.	____	____	____
	c. Trace opening balances to the working papers for the preceding audit.	____	____	____
	d. For bank accounts opened and closed during the year (period) trace to authorization in the minutes of the board of directors meetings.	____	____	____

Obj.		Done By	Date	W/P Ref.
A B C [D]	4. Obtain copies of the bank reconciliations as of the balance sheet date and perform the following:			
	a. Trace the book balance to the balance per the general ledger control account and to the working lead schedule or trial balance.			
	b. Compare the bank balance to the cut-off bank statement and to the standard form to confirm account balance information with financial institutions.			
	c. Test the clerical accuracy of the reconciliation.			
	d. Review and explain unusual reconciling items and trace to appropriate subsequent disposition.			
	e. Trace deposits in transit to the cut-off bank statement(s) and ascertain whether the time lag is reasonable.			
	f. Inspect selected paid checks returned with the cut-off bank statement. Examine the cancellation date on the paid checks to identify any checks that were not recorded in the period under audit. Trace checks drawn prior to the end of the period under audit to the list of outstanding checks and to the cash disbursements journal and agree items such as date, payee, and amount.			
	g. List and investigate any unusual checks including checks drawn to "bearer" or "cash."			
	h. List and investigate any outstanding checks of $__ or over, which did not clear the banks within a reasonable period to ascertain that the disbursements are proper.			
A B C [D]	5. Obtain or prepare an analysis of cash in savings banks and cash invested in certificates of deposit including identity of the individual banks and accounts or certificates, interest rates, maturities for certificates of deposit, opening and closing balances, activity during the year, and related interest income accrued and collected; perform the following:			
	a. Trace book balances and related income to the general ledger control account.			
	b. Test the footings and crossfootings.			
	c. Obtain the standard form to confirm account balance information with financial institutions from the bank of balances at the close of the year (or period), related interest rates and methods of computation, and amounts.			
	d. Examine passbooks and certificates of deposit, comparing them to bank confirmation; be alert for unrecorded passbook transactions or substituted certificates.			
	e. Recompute (all or on a test basis) amounts of interest earned and trace amounts to the related income accounts.			
B C	6. Prepare a bank transfer schedule providing column headings for the following:			
	a. Name of disbursing bank			
	b. Check number or other reference			
	c. Amount			
	d. Date disbursed per books			
	e. Date disbursed per bank			
	f. Name of receiving bank			
	g. Date deposited per books			
	h. Date deposited per bank			
	i. Perform the following:			

Obj.		Done By	Date	W/P Ref.
	(1) Review the cash receipts and disbursements journals, bank statements and related paid checks (including the cut-off bank statements) for the last. . . . days before the first. . . . days after the closing date of the year (period) and list all bank transfers (or each transfer of $__ or over) on the transfer schedule.	____	____	____
	(2) Review the schedule to determine that the deposit and disbursement side of each transfer is recorded in the proper period and that any time lag between book and bank entries appears reasonable. Trace incompleted transfers to the schedule of outstanding checks and/or deposits in transit.	____	____	____
B	7. If cut-off statements and related paid checks are not independently received by the auditor directly from the bank, obtain the bank statements and related paid checks for the month following the balance sheet date and perform the following:			
	a. Inspect bank statements for erasures and prove arithmetic accuracy of the statements (opening balance plus total deposits and other credits, less the closing balance equals total disbursements and other charges).	____	____	____
	b. Examine paid date of each check and debit memo to ascertain it was paid by the bank during the period covered by the bank statements.	____	____	____
	c. Foot the paid checks and debit memos to ascertain that the total agrees with total charges per the bank statements.	____	____	____
	d. Request banks to confirm the balance at the end of the statement period.	____	____	____
A B C D	8. On receiving the banks' responses to standard forms to confirm account balance information with financial institutions:			
	a. Ascertain that all of the inquiries have been answered. If any inquiries have not been answered, telephone or correspond with the bank to obtain the missing information (in writing).	____	____	____
	b. Trace the bank balances to the copies of applicable bank reconciliations included in the working papers; and accumulate the responses for use in work on liabilities.	____	____	____
	9. Return the cut-off bank statements with related paid checks and other bank memoranda to the client and obtain a receipt.	____	____	____
	B. Cash Funds and Petty Cash—Substantive Test Procedures			
A B C D	1. Identify all funds, including locations, custodians, amounts and purpose and decide:			
	a. Which funds are to be counted and, if so, whether to count them simultaneously and whether simultaneous control and inspection of other assets, such as negotiable securities, is also necessary.	____	____	____
	b. Timing of counts to be at a preliminary date, the balance sheet date or subsequent to the balance sheet date.	____	____	____
A B C D	2. Count all undeposited cash, petty cash, unclaimed wages, stamps, etc., in the presence of the custodian (A client's representative should be present at all times during the count.) and:			
	a. List currency and coins counted by denomination.	____	____	____
	b. List other items such as stamps, checks, and vouchers; examine vouchers as to date, amount, payer, authorization, signature, account charged, and documentation. Identify large or unusual amounts for possible follow-up.	____	____	____
	c. Trace the fund balance per the count to the balance per the general ledger.	____	____	____

Obj.		Done By	Date	W/P Ref.
	d. List all unusual items such as postdated checks or vouchers prepared in pencil for discussion with a responsible member of the client's staff.	____	____	____
	e. If petty cash reimbursement checks are included in the fund, trace the amounts to cash book entries dated prior to the count.	____	____	____
	f. Have the custodian sign a receipt at the conclusion of the count.	____	____	____
A B C D	3. Consider whether to confirm funds at branch offices and other locations which are not scheduled for a physical count.	____	____	____
	C. Section Completion			
	1. The objectives of this audit program have been met.	____	____	____

This audit program section has been completed in accordance with firm policy.

______________________________	____	____	____
Done by			
______________________________	____	____	____
Reviewed by			

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Obj.		Done By	Date	W/P Ref.

.055 IV. Low Risk Cash

Financial Statement Assertions:

1. Existence or occurrence.
2. Completeness
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Objectives:

A. Existence of cash—to determine that cash exists and is owned by the entity. (Assertions 1 and 3)

B. Proper cut-off—To determine that cash balances reflect a proper cut-off of cash receipts and disbursements. (Assertions 1, 2 and 4)

C. Cash complete—To determine that cash balances as presented in the balance sheet properly reflect all cash and cash items on hand, in transit, or on deposit with third parties. (Assertions 1, 2 and 5)

D. Proper classification—To determine that cash balances are properly classified in the financial statements and any restrictions on the availability of funds, including compensating balances, are properly disclosed. (Assertions 3 and 5)

E. GAAP conformity—To determine that the financial statement presentation and disclosure of cash is in conformity with generally accepted accounting principles consistently applied. (Assertion 5)

NOTE: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Procedures:

A. Cash in Banks—Substantive Test Procedures

Obj.	Procedure	Done By	Date	W/P Ref.
	1. A determination has been made that there is a low level of combined inherent risk and control risk for all assertions related to cash.	____	____	____
[A] [B] [C] [D] [E]	2. Review the activity in the general ledger for the cash accounts for the period being audited and:			
	a. Note and investigate any entries which appear unusual in source or amount.	____	____	____
	b. Compare the opening balance(s) for the period with the final closing balance(s) per the working papers and reports for the preceding period.	____	____	____

Obj.		Done By	Date	W/P Ref.
	3. Obtain or prepare a comparative listing of the component bank account(s) and petty cash fund balances as of the closing and opening balance sheet dates for the year (period) being audited:			
	a. Trace closing balances to the general ledger and working papers on bank reconciliations and petty cash funds.			
	b. Trace opening balances to the working papers for the preceding audit.			
	c. For bank accounts opened and closed during the year (period) trace to authorization in the minutes of the board of directors meetings.			
A B C	4. Confirm bank balances (using standard form to confirm account balance information with financial institutions) as of the balance sheet date for all banks used during the year.			
B C	5. Arrange to obtain cut-off bank statements and the related paid checks directly from the banks for ____ days following the balance sheet date.			
A B C [D]	6. Obtain copies of the bank reconciliations as of the balance sheet date.			
	7. List and examine any checks which are being "held" at year end and note reason for being "held".			
A B C [D]	8. Obtain or prepare an analysis of cash in savings banks and cash invested in certificates of deposit including identity of the individual banks and accounts or certificates, interest rates, maturities for certificates of deposit, opening and closing balances, activity during the year, and related interest income accrued and collected; perform the following:			
	a. Trace book balances and related income to the general ledger control account.			
	b. Examine passbooks and certificates of deposit, comparing them to the standard form to confirm account balance with financial institutions; be alert for unrecorded passbook transactions or substituted certificates.			
	c. Recompute (all or on a test basis) amounts of interest earned and trace amounts to the related income accounts.			
A B C D E	9. On receiving the banks' responses to the standard form to confirm account balance with financial institutions:			
	a. Ascertain that all of the inquiries have been answered. If any inquiries have not been answered, telephone or correspond with the bank to obtain the missing information (in writing).			
	b. Trace the bank balances to the copies of applicable bank reconciliations included in the working papers; and accumulate the responses for use in work on liabilities.			
A B C D E	10. On receiving the cut-off bank statements:			
	a. Agree paid checks to bank reconciliations.			
	b. Agree deposits in transit to bank reconciliations.			
	c. Return the cut-off bank statements with related paid checks and other bank memoranda to the client and obtain a receipt.			
[A] [B] [C] [D]	11. Calculate the following ratios and investigate unusual results:			
	a. Current year balance(s) to previous year balance(s).			
	b. Current year balance(s) to budget.			
	c. Acid-test ratio.			

Obj.		Done By	Date	W/P Ref.
	B. Cash Funds and Petty Cash—Substantive Test Procedures			
A B C D	1. Identify all funds, including locations, custodians, amounts, and purpose.	____	____	____
A B C D	2. Count, on a test basis (dependent upon dollar value) undeposited cash, petty cash, unclaimed wages, stamps, etc., in the presence of the custodian (a client's representative should be present at all times during the count) and:			
	a. List currency and coins counted by denomination.	____	____	____
	b. List other items such as stamps, checks, and vouchers; examine vouchers as to date, amount, payer, authorization, signature, account charged, and documentation. Identify large or unusual amounts for possible follow-up.	____	____	____
	c. Trace the fund balance per the count to the balance per the general ledger.	____	____	____
	d. List all unusual items such as postdated checks or vouchers prepared in pencil for discussion with a responsible member of the client's staff.	____	____	____
	e. If petty cash reimbursement checks are included in the fund, trace the amounts to cash book entries dated prior to the count.	____	____	____
	f. Have the custodian sign a receipt at the conclusion of the count.	____	____	____
	C. Section Completion			
	1. The objectives of this audit program have been met.	____	____	____

This audit program section has been completed in accordance with firm policy.

Done by	____	____	____
Reviewed by	____	____	____

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Obj.		Done By	Date	W/P Ref.

.060 V. Investments

Financial Statement Assertions:

1. Existence or occurrence.
2. Completeness.
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Objectives:

A. Existence of investment—To determine that the entity owns the investments at the balance sheet date and has physical evidence of ownership (securities, receipts from responsible custodians, etc.). (Assertions 1, 2 and 3)

B. Proper Valuation—To determine that the market or other fair value of the investments has been determined as objectively as practicable. (Assertion 4)

C. Income recognition—To determine that related income from the investments is properly recorded and received. (Assertions 2, 3 and 4)

D. Restrictions identified—To determine that restrictions, pledges or liens on any of the investments and related liabilities are identified and adequately disclosed in the financial statements. (Assertions 1, 2, 3 and 5)

E. GAAP conformity—To determine that the financial statement presentation and disclosure of investments and related income (classification, amounts such as cost, market, share of equity) is in conformity with generally accepted accounting principles consistently applied. (Assertion 5)

NOTE: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Procedures:

A. Substantive Test Procedures

Obj.	Procedure	Done By	Date	W/P Ref.
A B C D E	1. Were the following items considered:			
	a. Results of the tests of controls performed as it relates to investments and related income.	____	____	____
	b. Plans for physical inspection, confirmation procedures, or a combination of both, including whether this should be done on a surprise basis, as of the balance sheet date, or both.	____	____	____

Obj.		Done By	Date	W/P Ref.
	c. Need for control of investments and simultaneous control of such related items as cash funds and detail subsidiary records of investments when performing the inspections and confirmation selections and mailings.			
	d. Competent independent sources for market valuation.			
	e. Competent independent sources for substantiating declaration and remittance of investment income.			
A B C E	2. Obtain or prepare detailed analyses of investments showing:			
	a. Classification between held-to-maturity, available-for-sale, or trading securities, and securities accounted for under the equity method.			
	b. Classification between current and non-current portfolios of held-to-maturity securities and available-for-sale securities.			
	c. Description of the security, including any interest rate and maturity of debt, the dividend rate on cumulative preference shares, etc.			
	d. Number of shares, par value, or face amount held at the end of the preceding period, and the balance at cost and at market or equity, if applicable, together with any unamortized premium or discount on bonds.			
	e. Additions including date, number of shares, par values or face amounts, and cost.			
	f. Sales and dispositions including date, number of shares, par value or face amounts, cost, proceeds, and realized gain or loss.			
	g. Number of shares, par values, or face amounts held at the end of the period, and the balance at cost and at fair value or equity, if applicable, together with any unamortized premium or discount on bonds.			
	h. Related holding gains and losses at the beginning and the end of the period and changes therein.			
	i. Investment income (dividends, interest, etc.) for individual investments—accrued at the end of the previous period, earned during the current period, collected during the period and accrued at the end of the current period.			
B	3. Foot and crossfoot the analyses.			
[E]	4. Trace ending totals to the general ledger and financial statement assembly sheets; trace opening balances to the prior period audit working papers.			
A B [D] [E]	5. Inspect securities on hand in the presence of the custodian (including treasury stock and securities held as collateral) at the balance sheet date or at a date shortly before of after, and examine supporting evidence (for example, bank and broker advices) for transactions between the inspection date and balance sheet date.			
	a. Ascertain that certificates issued in nominee names are owned by the client.			
	b. Note certificate or serial numbers, if useful.			
	c. If the investment is in the debt or equity of a nonpublic entity, consider obtaining confirmation from the issuer or trustee.			
	d. Obtain a signed receipt.			
A	6. Obtain positive confirmation as of the balance sheet date for investments held by independent custodian; consider whether inspection of investments held by custodians is necessary.			
C D E	7. Examine contractual terms of debt securities and preferred stocks.			

Obj.		Done By	Date	W/P Ref.
[A]	8. Determine that sales and purchases were properly approved; trace transactions to minutes of the Board of Directors or Finance Committee meetings.	____	____	____
A C E	9. Examine bank or broker's advices and custodian's reports in support of purchases and sales.	____	____	____
C E	10. Determine that gain or loss on disposition of a security has been computed and accounted for properly.	____	____	____
A C E	11. Trace payments for purchases to cancelled checks and proceeds from sales to entries in cash book.	____	____	____
C	12. By reference to published sources, by computation, and by examination of the cash receipts journal, determine that income from securities has been properly accrued or collected.	____	____	____
B C E	13. Determine that the amortization of premium and discount on debt securities, where applicable, has been properly computed and accounted for.	____	____	____
B E	14. For investments in nonpublic entities and investments carried on the equity method, compare carrying value to information in the most recently available audited financial statements. If necessary, use financial reports and statements issued later than the most recently available audited financial statements.	____	____	____
B C E	15. Compute the unrealized gain or loss on both the trading and available-for-sale debt and marketable equity securities.	____	____	____
B C E	16. Determine that the unrealized gains or losses on securities have been included either in the income statement or in the equity section of the balance sheet as appropriate.	____	____	____
E	17. Determine that any transfers between categories of investments have been properly recorded.	____	____	____
B	18. Determine that any permanent impairment in value has been properly recognized and accounted for.	____	____	____
	B. Section Completion			
	1. The objectives of this audit program have been met.	____	____	____

This audit program section has been completed in accordance with firm policy.

______________________________ ____ ____ ____

Done by

______________________________ ____ ____ ____

Reviewed by

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Obj.		Done By	Date	W/P Ref.

.065 VI. Low Risk Investments

Financial Statement Assertions:

1. Existence or occurrence.
2. Completeness.
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Objectives:

A. Existence of investment—to determine that the entity owns the investments at the balance sheet date and has physical evidence of ownership (securities, receipts from responsible custodians, etc.). (Assertions 1, 2 and 3)

B. Proper Valuation—To determine that the market or other fair value of the investments has been determined as objectively as practicable. (Assertion 4)

C. Income recognition—To determine that related income from the investments is properly recorded and received. (Assertions 2, 3 and 4)

D. Restrictions identified—To determine that restrictions, pledges or liens on any of the investments and related liabilities are identified and adequately disclosed in the financial statements. (Assertions 1, 2, 3 and 5)

E. GAAP conformity—To determine that the financial statement presentation and disclosure of investments and related income (classification, amounts such as cost, market, share of equity) is in conformity with generally accepted accounting principles consistently applied. (Assertion 5)

NOTE: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Procedures:

A. Substantive Test Procedures

Obj.	Procedure	Done By	Date	W/P Ref.
	1. A determination has been made that there is a low level of combined inherent risk and control risk for all assertions related to investments.	_____	_____	_____
[A] [C]	2. Review the activity in the general ledger for the investment accounts for the period being audited and:			
	a. Note and investigate any entries which appear unusual in source or amount.	_____	_____	_____

Obj.		Done By	Date	W/P Ref.
	b. Compare the opening balance(s) for the period with the final closing balance(s) per the working papers and reports for the preceding period.	_____	_____	_____
A B C E	3. Obtain or prepare detailed analyses of investments showing:			
	a. Classification between held-to-maturity, available-for-sale, or trading securities, and securities accounted for under the equity method.	_____	_____	_____
	b. Classification between current and non-current portfolios of held-to-maturity securities and available-for-sale securities.	_____	_____	_____
	c. Description of the security, including any interest rate and maturity of debt, the dividend rate on cumulative preference shares, arrearages, etc.	_____	_____	_____
	d. Number of shares, par value, or face amount held at the end of the preceding period, and the balance at cost and at market or equity, if applicable, together with any unamortized premium or discount on bonds.	_____	_____	_____
	e. Additions including date, number of shares, par values or face amounts, and cost.	_____	_____	_____
	f. Sales and dispositions including date, number of shares, par value or face amounts, cost, proceeds, and realized gain or loss.	_____	_____	_____
	g. Number of shares, par values, or face amounts held at the end of the period, and the balance at cost and at market or equity, if applicable, together with any unamortized premium or discount on bonds.	_____	_____	_____
	h. Related valuation allowances at the beginning and the end of the period and changes therein.	_____	_____	_____
	i. Investment income (dividends, interest, etc.) for individual investments—accrued at the end of the previous period, earned during the current period, collected during the period and accrued at the end of the current period.	_____	_____	_____
B	4. Foot and crossfoot the analyses.	_____	_____	_____
[E]	5. Trace ending totals to the general ledger and trial balance; trace opening balances to the prior period audit working papers.	_____	_____	_____
	6. Inspect securities on hand in the presence of the custodian (including treasury stock and securities held as collateral) at the balance sheet date or at a date shortly before or after, and examine supporting evidence (for example, bank and broker advices) for transactions between the inspection date and balance sheet date and:			
	a. Ascertain that certificates issued in nominee names are owned by the client.	_____	_____	_____
	b. Note certificate or serial numbers, if useful.	_____	_____	_____
	c. If the investment is in the debt or equity of a nonpublic entity, consider obtaining confirmation from the issuer or trustee.	_____	_____	_____
	d. Obtain a signed receipt.	_____	_____	_____
	7. Consider confirming significant investments held by custodians.	_____	_____	_____
	8. Determine that any unrealized gains and losses, and transfers between categories of investments have been properly recorded.	_____	_____	_____
	9. Determine that any permanent impairment in value has been properly recognized and accounted for.	_____	_____	_____
[A] [C] [D] [E]	10. Calculate and evaluate the following:			
	a. Acid-test ratio (current assets − [inventories + prepaids]/current liabilities).	_____	_____	_____
	b. Interest income to interest bearing investments.	_____	_____	_____
	c. Dividend income to marketable equity securities.	_____	_____	_____
	d. Budgeted investments to actual.	_____	_____	_____
	e. Prior period amounts to current period.	_____	_____	_____

Obj.		Done By	Date	W/P Ref.
	B. Section Completion			
	1. The objectives of this audit program have been met.	____	____	____

This audit program section has been completed in accordance with firm policy.

________________________ Done by	____	____	____
________________________ Reviewed by	____	____	____

> **The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.**

Obj.		Done By	Date	W/P Ref.

.070 VII. Trade Accounts and Notes Receivable

Financial Statement Assertions:

1. Existence or occurrence.
2. Completeness.
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Objectives:

A. Existence of accounts receivable—To determine that the receivables exist, are authentic obligations owed to the entity, contain no significant amounts that should be written off, and that allowances for doubtful accounts are adequate and not excessive. (Assertions 1, 3 and 4)

B. Proper disclosure—To determine that proper disclosure is made of any pledged, discounted or assigned receivables. (Assertions 3 and 5)

C. Revenue recognition—To determine that interest on accounts and notes receivable has been properly recorded. (Assertions 2, 3 and 4)

D. GAAP conformity—To determine that presentation and disclosure of receivables is in conformity with generally accepted accounting principles consistently applied. (Assertion 5)

NOTE: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Procedures:

A. Substantive Test Procedures

Obj.		Done By	Date	W/P Ref.
	1. Based on the assessed level of risk, decide on the following:			
	a. If receivables will be confirmed.	_____	_____	_____
	b. If confirmation work will be performed:	_____	_____	_____
	(1) Extent of confirmation procedures.	_____	_____	_____
	(2) Form of confirmation (positive, negative or a combination of both).	_____	_____	_____
	(3) Timing of confirmation procedures (as of balance sheet date or some other date).	_____	_____	_____
	(4) Anticipated scope of alternative procedures.	_____	_____	_____
	c. Approach for reviewing and evaluating adequacy of allowances.			
[A]	2. Review activity in the general ledger control accounts for trade accounts receivable for the period being audited and:			

Obj.		Done By	Date	W/P Ref.
	a. Note and investigate any significant entries which appear unusual in amount or source.			
	b. Compare the opening balance for the period with the final closing balances per the working papers and reports for the preceding period.			
[A]	3. Analyze the relationship of receivables and sales (day's sales in accounts receivable) and compare with relationships for the preceding period(s). (SAS No. 56 [AU section 329])			
[A]	4. Obtain or prepare an aged trial balance of trade receivables as of the date selected for confirmation procedures. Note: In some situations, it may not be practicable to obtain an aged trial balance until after the mailing of confirmation requests, especially when confirmation procedures are coordinated with the client's regular billing cycle. In such instances obtain a trial balance (which may be an annotated tape) of trade receivables as of the confirmation date and perform the following:			
	a. Crossfoot the totals and refoot the total column and (selected or all) analysis columns.			
	b. Trace total to the general ledger control account and, if as of the balance sheet date, to the lead schedule or working trial balance.			
	c. On a test basis, trace entries for individual customers on the aging analysis (totals and aging detail) to the individual accounts in the accounts receivable subsidiary ledger and select individual accounts from the subsidiary ledger and trace totals and aging detail to the aged trial balance. Test footings of individual customer accounts in the subsidiary ledger.			
	5. If accounts receivable are not confirmed, document the reason. One of the following is acceptable:			
	a. Accounts receivable are immaterial to the financial statements.			
	b. Use of confirmations would be ineffective.			
	c. Combined assessed level of inherent and control risk is low (as addressed in 1, above), and the assessed level, in conjunction with other evidence (analytical procedures or other substantive tests) reduced audit risk to an acceptably low level for applicable financial statement assertions.			
[A]	6. Select individual customer accounts for confirmation procedures from the aged trial balance (or trial balance) and arrange for the preparation of confirmation requests to be mailed under the auditor's control and tested as follows:			
	a. Trace individual confirmation requests as to balances and addresses to the subsidiary accounts receivable records. Send confirmations (using envelopes with the auditor's return address) and prepare confirmation statistics.			
	b. If client requests that any accounts be excluded from the confirmation process, obtain explanations; consider reviewing such records as correspondence files to substantiate the explanation and perform appropriate alternative procedures with respect to the amounts.			
	c. Trace confirmation replies to the trial balance and investigate replies with differences.			
	(1) Note: The auditor may prepare a control of exceptions such as copies of replies or a list and arrange for the client's staff to investigate the differences and accumulate supporting documentation for the auditor's review.			
	d. Obtain new addresses for all confirmations returned by the post office and remail.			

Obj.		Done By	Date	W/P Ref.
	e. Send second requests for all unanswered positive confirmation requests. Consider sending third requests by registered or certified mail, and performing alternative auditing procedures.			
	f. Perform alternative auditing procedures for unanswered positive confirmation requests.			
	g. Summarize the results of the confirmation procedures.			
	h. Subsequent to the confirmation date, consider reviewing the customer's ledger and remittance advices for cash receipts.			
[A]	7. For positive confirmation requests to which no reply was received, accounts which declined to provide confirmation information and accounts which the client requested not be confirmed:			
	a. Test items subsequently paid to remittance advices which identify the specific invoices paid.			
	b. Examine customer's purchase orders, related invoices and shipping documents for amounts that are not supported by remittance advices which identify the specific invoices paid.			
	c. Establish the existence of the customer by reference to such sources as Dun and Bradstreet Reference Book.			
[A]	8. If accounts receivable were confirmed as of a date other than the balance sheet date, obtain an analysis of transactions between the confirmation and balance sheet dates, trace amounts to books of original entry, and review the analysis and books for significant unusual entries.			
ABC	9. Obtain or prepare an analysis of trade notes receivable including the following information:			
	a. Maker			
	b. Date made/date due			
	c. Original terms of repayment			
	d. Collateral, if any			
	e. Interest rate			
	f. Balance at the end of last period			
	g. Principal—additions, payments			
	h. Interest income—at the end of the preceding period, earned during the current period, received during the current period, and accrued at the end of the current period.			
	(1) Foot schedule and trace totals to applicable general ledger accounts.			
	(2) Physically inspect all notes in possession of the client.			
	(3) Request positive confirmation of the terms and balances of notes with makers (as of the balance sheet date or other date). Investigate any differences.			
	(4) Confirm notes out for collection with collection agents.			
	(5) Inspect collateral for notes, if any, making sure that items were not included in corresponding asset accounts of the company.			
	(6) Recompute interest income, accrued interest and unearned discount; trace interest collections, if any, to the cash receipts journal. Ascertain that computations of interest and recognition of interest income is in conformity with APB Opinion No. 21 [AC section I69].			
A B [D]	10. Ascertain whether any accounts or notes have been assigned, pledged or discounted by reference to minutes, review of agreements, confirmation with banks, etc.			

Obj.		Done By	Date	W/P Ref.
A [D]	11. Ascertain whether any accounts or notes receivable are owed by employees or related parties such as officers, directors, shareholders and affiliates, and:			
	a. Obtain an understanding of the business purpose for the transactions which resulted in balances.	____	____	____
	b. Ascertain that transactions were properly authorized.	____	____	____
	c. Obtain positive confirmations of the balances (as of the balance sheet date or some other date) except for intercompany accounts with affiliated companies which the firm is concurrently examining.	____	____	____
	d. Determine if any notes repaid prior to the balance sheet date have since been renewed.	____	____	____
ABC [D]	12. Obtain or prepare an analysis of the allowance for doubtful accounts for the period, and:			
	a. Review accounts written off during the period and determine that significant write-offs have been properly authorized. Examine supporting documentation, including correspondence with the customer. (Such correspondence may indicate a broader problem.)	____	____	____
	b. Review adequacy of the allowance and related provision (SAS No. 57 [AU section 342]):			
	(1) Review the aged trial balance as of the balance sheet date with the client's credit manager or other responsible individual to identify accounts of a doubtful nature and allowances required; review correspondence files and other relevant data in support of client's representations. Items reviewed should include past due amounts and significant amounts whether or not past due.	____	____	____
	(2) Examine credit reports for delinquent and large accounts.	____	____	____
	(3) Review confirmation exceptions for indication of amounts in dispute.	____	____	____
	(4) Consider whether accounts receivable that have been connected to notes receivable pose any unusual credit risk.	____	____	____
	(5) Analyze and review trends for the following relationships (SAS No. 56 [AU section 329]):			
	(a) Accounts receivable to credit sales.	____	____	____
	(b) Allowance for doubtful accounts to accounts receivable (in total and in relation to past due categories per aging analysis).	____	____	____
	(c) Sales to returns and allowances.	____	____	____
	(d) Expense provisions for doubtful accounts to net credit sales.	____	____	____
	(e) Expense provisions for doubtful accounts to write-offs.	____	____	____
	(f) Moving average relationship of write-offs to trade receivables.	____	____	____
	(g) Average balance per customer.	____	____	____
	(h) Ratio of accounts receivable to current assets.	____	____	____
	(i) Ratio of notes receivable to accounts receivable.	____	____	____
	(j) Ratio of renewed notes to notes receivable.	____	____	____
	c. Identify differences, if any, between the book and tax basis for the allowance for doubtful accounts and related expense provision; summarize information required for determining income taxes currently payable and deferred.	____	____	____
	d. Review revenue, receivable and cash receipts transactions after the balance sheet date including discounts taken, credits allowed, and write-offs for unusual transactions (especially concerning past due balances and large accounts).	____	____	____

Obj.		Done By	Date	W/P Ref.
	B. Section Completion			
	1. The objectives of this audit program have been met.	____	____	____

This audit program section has been completed in accordance with firm policy.

______________________________	____	____	____
Done by			
______________________________	____	____	____
Reviewed by			

The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

Obj.		Done By	Date	W/P Ref.

.075 VIII. Low Risk Trade Accounts and Notes Receivable

Financial Statement Assertions:

1. Existence or occurrence.
2. Completeness
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Objectives:

A. Existence of accounts receivable—To determine that the receivables exist, are authentic obligations owed to the entity, contain no signifcant amounts that should be written off, and that allowances for doubtful accounts are adequate and not excessive. (Assertions 1, 2, 3 and 4)

B. Proper disclosure—To determine that proper disclosure is made of any pledged, discounted or assigned receivables. (Assertions 3 and 5)

C. Revenue recognition—To determine that interest on accounts and notes receivable have been properly recorded. (Assertions 2, 3 and 4)

D. GAAP conformity—To determine that presentation and disclosure of receivables is in conformity with generally accepted accounting principles consistently applied. (Assertion 5)

NOTE: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Procedures:

A. Substantive Test Procedures

Obj.	Procedure	Done By	Date	W/P Ref.
	1. A determination has been made that there is a low level of combined inherent risk and control risk for all assertions related to accounts receivable.	____	____	____
[A]	2. Review activity in the general ledger accounts for trade accounts and notes receiveable for the period being audited and:			
	a. Note and ivestigate any significant entries which appear unusual in amount or source.	____	____	____
	b. Compare the opening balance(s) for the period with the final closing balance(s) per the working papers and reports for the preceding period.	____	____	____

Obj.		Done By	Date	W/P Ref.
[A]	3. Obtain or prepare an aged trial balance of trade receivables as of the financial statement date and perform the following:			
	a. Trace total to the general ledger control account and to the lead schedule or working trial balance.	____	____	____
	b. On a test basis, trace balances and entries for individual customers on the aging analysis (totals and aging detail) to the individual accounts in the accounts receivable subsidiary ledger and select individual accounts from the subsidiary ledger and trace totals and aging detail to the aged trial balance. Test footings of individual customer accounts in the subsidiary ledger.	____	____	____
	c. Analyze changes in individual account balances as well as aged balances and investigate unusual changes.	____	____	____
	d. Compare with industry standards, if applicable.	____	____	____
	4. If accounts receivable are not confirmed, document the reason. One of the following is acceptable:			
	a. Accounts receivable are immaterial to the financial statements.	____	____	____
	b. Use of confirmations would be ineffective.	____	____	____
	c. Combined assessed level of inherent and control risk is low (as addressed in 1, above), and the assessed level, in conjunction with other evidence (analytical procedures or other substantive tests) reduced audit risk to an acceptably low level for applicable financial statement assertions.	____	____	____
	5. Select individual customer accounts for confirmation procedures from the aged trial balance and arrange for the preparation of confirmation requests to be mailed under the auditor's control and tested as follows:			
	a. Trace individual confirmation requests (balances and addressees) to the subsidiary accounts receivable records. Send out confirmations (using envelopes with the auditor's return address) and prepare confirmation statistics.	____	____	____
	b. If client requests that any accounts be excluded from the confirmation process, obtain explanations; consider reviewing records such as correspondence files to substantiate the explanation and perform appropriate alternative procedures with respect to the amounts.	____	____	____
	c. Trace confirmation replies to the trial balance and investigate replies with differences.	____	____	____
	d. Obtain new address for all confirmations returned by the post office and remail.	____	____	____
	e. Evaluate and document the factors related to unanswered confirmation requests, i.e., period nonresponses are associated (year-end transactions), type of sale, etc., as well as dollar value of nonresponses for determining misstatement of financial statements.	____	____	____
	f. If alternative procedures should be performed based on 6 above, send second requests for unanswered positive confirmation requests. Consider sending third requests by registered or certified mail.	____	____	____
	g. Perform alternative procedures for unanswered positive confirmation requests, i.e., subsequent cash receipts, examining shipping documents, etc.	____	____	____
	h. Summarize the results of the confirmation procedures.	____	____	____
A B C	6. Obtain or prepare an analysis of trade notes receivable as of the balance sheet date and perform the following:			

Obj.		Done By	Date	W/P Ref.
	a. Recompute interest income, accrued interest and unearned discount. Ascertain that computations of interest and recognition of interest income is in conformity with APB Opinion No. 21 [AC section I69].			
	b. Compare with industry standards, if available.			
	c. Ascertain that the information necessary to make the disclosures for FASB Statement No. 105 (AC section F25) has been obtained.			
A B [D]	7. Ascertain whether any accounts or notes have been assigned, pledged or discounted by reference to minutes, review of agreements, etc.			
A [D]	8. Ascertain whether any accounts or notes receivable are owed by employees or related parties such as officers, directors, shareholders and affiliates, and:			
	a. Obtain an understanding of the purpose for the transactions which resulted in balances.			
	b. Ascertain that transaction amounts and interest rates were properly authorized.			
	c. Determine if any notes repaid prior to the balance sheet date have since been renewed.			
A B C [D]	9. Obtain or prepare an analysis of the allowance for doubtful accounts for the period, and:			
	a. Review accounts written off during the period and determine that significant write-offs have been properly authorized.			
	b. Review adequacy of the allowance and related provision (SAS No. 57 [AU section 342]):			
	(1) Review the aged trial balance as of the financial statement date to identify accounts of a doubtful nature and allowances required. Items reviewed should include past due amounts and significant amounts whether or not past due.			
	(2) Examine credit reports for significant potential delinquent accounts.			
	c. Review revenue, receivable and cash receipts transactions after the balance sheet date including discounts taken, credits allowed, and write-offs for unusual transactions (especially concerning past due balances and large accounts).			
A C	10. Analyze and review trends for the following relationships (SAS No. 56 [AU section 329]):			
	a. Accounts receivable to credit sales.			
	b. Allowance for doubtful accounts to accounts receivable (in total and in relation to past due categories per aging analysis).			
	c. Allowance for bad debts as a percentage of accounts receivable.			
	d. Returns and allowances to sales.			
	e. Expense provisions for doubtful accounts to net credit sales.			
	f. Expense provisions for doubtful accounts to write-offs.			
	g. Moving average relationship of write-offs to trade receivables.			
	h. Average balance per customer.			
	i. Ratio of accounts receivable to current assets.			
	j. Ratio of notes receivable to accounts receivable.			
	k. Ratio of renewed notes to notes receivable.			
	l. Days sales in accounts receivable.			
	m. Net sales to accounts receivable.			

Obj.		Done By	Date	W/P Ref.
	B. Section Completion			
	1. The objectives of this audit program have been met.	____	____	____

This audit program section has been completed in accordance with firm policy.

______________________	____	____	____
Done by			
______________________	____	____	____
Reviewed by			

The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

Obj.		Done By	Date	W/P Ref.

.080 IX. Inventories

Financial Statement Assertions:

1. Existence of occurrence.
2. Completeness.
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Objectives:

A. Inventory exists—To determine that the inventory exists and is the client's property. (Assertions 1 and 3)

B. Quantity and condition—To determine that the client has taken reasonable care in determining the physical quantities and identifying the condition (normal, slow moving, obsolete) of its inventory. (Assertions 2 and 4)

C. Clerical accuracy—To determine that the inventories are summarized and priced with clerical accuracy, and the records have been adjusted to the physical inventory. (Assertions 2 and 4)

D. GAAP conformity—To determine that inventory classifications and carrying amounts are determined and presented in the financial statements in conformity with generally accepted accounting principles consistently applied (for example, assumptions about the cost flow, such as FIFO and LIFO, and lower of cost or market considerations). (Assertion 5)

E. Encumbrances identified—To determine that any encumbrances such as pledges or liens are identified and adequately disclosed in the financial statements. (Assertions 3, 4 and 5)

NOTE: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Procedures:

A. Substantive Test Procedures—General

1. Were the following items considered:
   a. Results of the test of controls performed as they relate to inventories, production costs, and cost of sales. (A particularly significant issue is whether accounting controls over inventory transactions and balances are of sufficient strength to allow performing the physical count sooner than the balance sheet date.) ____ ____ ____
   b. Timely identification of the locations of the physical inventories and their relative materiality by location. ____ ____ ____

Obj.		Done By	Date	W/P Ref.
	c. Timely review of the client's plans and instructions for taking the physical inventory and accumulating, pricing, and summarizing the results. (For example, will prenumbered tags be used and accounted for? Will counts be independently checked? Who is responsible for summarizing the physical inventory?)			
	d. Whether involvement of specialists is required (SAS No. 11 [AU section 336]).			
	e. Need for audit assistants based on timing of counts at various locations, materiality of the amounts involved, and degree of difficulty of the observation.			
	f. Whether any inventory is held by third parties such as public warehouses and consignees and, if so, whether to obtain positive confirmation or because of materiality observe its physical count (SAS No. 1, section 331.14-.15, as amended by SAS No. 43, paragraph 3 [AU section 331.14]).			
	g. Information to be recorded during observation when noting test counts for subsequent tracing to summarization of the physical inventory.			
	h. Information to be recorded at time of the physical count for subsequent tracing to other records as a cut-off test.			
	B. Before Observation of the Physical Inventory			
	Note: Some auditing procedures may serve to accomplish the purpose of both tests of controls and substantive tests. Certain steps that are listed here as illustrative substantive tests are also listed among illustrative tests of control for inventory. They are listed as tests of controls because they may serve to clarify and confirm the auditor's understanding of the internal control structure for inventory and cost of sales.			
	1. Tour the client's manufacturing or production facilities with a member of the client's organization familiar with production.			
AB [D]	2. On a test basis, select transactions for additions and deletions of inventory from such sources as receiving reports, requisitions to place materials into production, and shipping advices. Note the reference or control number, date, description, quantity, and dollar amount for each transaction selected. Trace the transactions to the perpetual inventory record and the cost accounting records, if any, used to determine unit or job costs. Perform similar tests selecting the transactions from the perpetual inventory records and/or cost accounting records and trace the transactions to receiving reports, requisitions, and shipping advices.			
	a. Note: This test may be coordinated with tests of controls for purchases, payables, and disbursements, and for revenues, receivables, and receipts.			
D	3. Obtain an analysis of overhead costs charged to inventories and over- and under-absorbed overhead. Review the amounts included in the overhead pool for propriety and perform the following:			
	a. Determine that overhead costs are being charged to inventory in accordance with an appropriate policy (for example, as a percent of direct labor).			
	b. Identify disposition of variances, if any, between actual overhead costs incurred and overhead costs applied to production and inventory. Determine that variances are reasonable. Determine that no excessive costs for idle plant are being charged to inventory.			
CD	4. If a job order cost system is used, obtain the job order ledger (or tabulation), select a period(s) and perform the following:			

Obj.		Done By	Date	W/P Ref.
	a. Trace total costs incurred to the voucher register (or cash disbursements journal), the payroll distribution, and support for overhead applied.	____	____	____
	b. Test the footings of the job order ledger by refooting the detail for selected subtotals and refooting the subtotals.	____	____	____
	c. Select .... job orders for jobs in process and completed jobs and perform the following:			
	(1) Examine authorization for the job order.	____	____	____
	(2) Trace materials used on a test basis at various times since inception of the job order to such supporting details as requisitions, purchase orders, receiving reports, and processed invoices. (Consider coordination with tests of controls for purchases.)	____	____	____
	(3) Trace direct labor costs to account distributions of the payroll registers and on a test basis to individual time reports or time cards. (Consider coordination with tests of controls for payroll.)	____	____	____
	(4) Trace application of overhead costs to analyses used to accumulate overhead costs; test computations and review for reasonableness.	____	____	____
	(5) Identify the status of the job (work in process, finished goods, or goods shipped) and trace through necessary summarization to the applicable general ledger account. Obtain explanation for any unreasonable time lag between completion and shipping dates for job orders performed for specific customers.	____	____	____
CD	5. For process cost systems, obtain the cost of production reports for each department within the production process for a selected period(s) and:			
	a. Trace quantities and dollar amounts for units received for selected departments to the quantities and dollar amount transferred out per the preceding department in the sequence of production.	____	____	____
	b. For each selected department, review the computations of total and unit costs for production transferred to the next department; on a test basis recompute unit costs and ascertain that costs for units lost in process are properly reallocated to surviving units.	____	____	____
	c. Trace material costs charged to the selected departments to appropriate journals and on a test basis to individual requisitions.	____	____	____
	d. Trace labor costs incurred to account distribution analyses of the payroll registers.	____	____	____
	e. Review the allocation of overhead.	____	____	____
	C. Observation of the Physical Inventory			
	1. Include the following in advance planning:			
	a. Review and evaluate the adequacy of the client's instructions for making the physical count.	____	____	____
	b. Consider attending the client's preparatory meetings for the physical count.	____	____	____
	c. If a specialist is to be involved, review and evaluate the professional qualifications and reputation of the specialist; obtain an understanding of the nature of the work to be performed by the specialist.	____	____	____
	d. Determine the nature and timing of confirmation requests needed from custodians of inventory such as public warehouses and consignees.	____	____	____
	e. Review adequacy of audit staffing arrangements.	____	____	____

Obj.		Done By	Date	W/P Ref.
	2. Tour the premises on arrival and ascertain whether the inventory arrangement is conducive to a satisfactory count; if the arrangement appears obviously unsatisfactory, recommend rearrangement.			
A	3. Ascertain that items on hand which are not the property of the client are clearly identified, segregated, and excluded from the count. Note such references as descriptions, quantities, serial numbers, and shipping advice numbers so that in subsequent tests of inventory summarization the auditor may determine whether the items were excluded from the physical count.			
[A]	4. Visit the shipping and receiving departments and record the control numbers for the last shipping advice and receiving report prepared prior to the physical count for subsequent tracing to accounting department records. Consider recording a few additional shipping advice and receiving report numbers for subsequent tracing.			
A B	5. Ascertain that receiving and shipping departments are informed that receipts after and shipments before the inventory cut-off are to be excluded from the count. Ascertain that receiving reports for items not included in the count are prominently marked "after inventory".			
B	6. Observe and note client's provision for segregation and/or clear identification of slow-moving, obsolete and/or damaged items; also be alert for such items among regular stock and if present, bring to the client's attention and note for subsequent consideration.			
[A] [B]	7. Inspect representative items of inventory and ascertain the source of their identification, description, status (work in process, finished goods, etc.), basis for count or measure (volume, weight, item tally, etc.). Inquire of both production personnel and personnel involved in the count about such items.			
[A] [B]	8. Observe and ascertain that the client's inventory instructions and procedures are being followed.			
[A] [B]	9. Ascertain that prenumbered inventory tickets on count sheets are properly controlled including:			
	a. Accounting for all tickets or sheets issued to count personnel.			
	b. Accounting for return of all tickets or sheets issued including those unused and spoiled as well as those used, at completion of the inventory.			
	c. Note series of tickets or count sheet numbers used and those unused or spoiled for subsequent tracing in tests of summarization.			
[A] [B]	10. Observe the count process and make test counts ascertaining that the identifications, descriptions, and quantities are being properly noted on the inventory tickets or count sheets. If inventory count sheets are used, select some items from the floor, make test counts and trace them to the sheets; select some entries from the sheets (include some items of greater dollar value) and trace them to items on the floor.			
[C]	11. Prepare a worksheet listing some items (include some items of greater dollar value) test counted, for subsequent tracing into the client's inventory summarization. Include on the worksheet for each item the inventory ticket or count sheet number, location, description, quantity per client, quantity per your test count, and other particulars essential for subsequent tracing to the inventory summarization. Bring test count differences to the client's attention during the count so they may be resolved in a timely manner. If test count differences are not isolated, it may be necessary to request a recount of a particular area or department.			
B C	12. Observe that all items of inventory are clearly ticketed or marked when counted to avoid omissions and/or duplications of counts.			
B C	13. Observe whether any items are not being counted and obtain an adequate explanation for their omission.			

Obj.		Done By	Date	W/P Ref.
A B	14. Note any movement of inventory during the count; obtain an explanation for the movement and record details from the applicable authorizing documents for consideration in review of the cut off.	____	____	____
	15. Prepare a memorandum on the observation of the physical inventory including:			
	a. Comment on the physical inventory arrangements.	____	____	____
	b. Implementation of the client's inventory instructions.	____	____	____
	D. Summarization—Physical Quantities			
A B C	1. Relate and trace informations, noted during observations of the physical, about control number for count tickets or count sheets used, to the client's summarization of the physical for reasonable assurance that only tickets or sheets used for the physical are included in the summarization of quantities. (Summarization of quantities may consist of the quantities per the final priced inventory or an intermediate tabulation of count tickets. In some instances the original count sheets may provide for entry of prices, extensions, and summarization of dollar amounts.)	____	____	____
B C	2. Trace test counts noted during the physical to the client's summarization of quantities.	____	____	____
A	3. Trace quantities confirmed by third parties to the summarization of quantities.	____	____	____
B C	4. Depending on the extent of the work in step 2 above and on the internal control structure over inventory summarization, select quantities for particular items from the summarization and trace them to the count tickets or count sheets; select quantities for particular items from the count tickets or sheets and trace them to the summarization of quantities.	____	____	____
A B C	5. If the client uses perpetual inventory records and the perpetuals are to be used to determine the year-end balance, trace items on a test basis to and from the physical inventory summaries; ascertain that the perpetuals were adjusted to the physical.	____	____	____
B C	6. Trace notes made at the observation for slow moving, obsolete, and/or damaged items to the client's summarization of quantities and determine if they are clearly identified as such.	____	____	____
B C	7. Test the cut-off information noted at the observation of the physical inventory as follows:			
	a. Select the last few shipping advices used before the count to the sales register; determine that the shipments were recorded as sales and charges to cost of sales as the dates shipped.	____	____	____
	b. Select a few shipping advices used after the count to the sales register and determine that the shipments were recorded as sales in the period after the date of the inventory.	____	____	____
	c. Select the last few receiving reports used before the count and determine that the related liability was recorded prior to or as of the count date.	____	____	____
B C	8. If the client uses a process cost system, trace selected quantities per the physical inventory to the departmental cost of production reports and determine that quantities have been adjusted to the physical inventory as of the date of the physical count.	____	____	____
	E. Prices and Summarization—Monetary Units			
D	1. Ascertain the methods followed concerning the flow of costs (FIFO, LIFO, moving average, etc.) and compare with working papers of the preceding year to ascertain whether the methods have been consistently applied.	____	____	____

Obj.		Done By	Date	W/P Ref.
C	2. For purchased materials and supplies included in inventory, trace unit costs to prices per recent (prior to year end) vendors' invoices and/or to prior year inventory if LIFO is used. Note dates per vendors' invoices and be alert for slow moving items. Ordinarily, sufficient invoices should be inspected to cover the quantities on hand.			
C D	3. Trace unit costs per the physical inventory of work-in-process and finished goods, on a test basis, to the cost accounting records and perform the following:			
	a. Obtain and review trial balances or tabulations of detailed components of production costs incurred for the year (period) and compare with the equivalent for the preceding year (period).			
	(1) Obtain and note explanations for apparent inconsistencies in classification and significant fluctuations in amounts.			
	(2) Ascertain that the cost classifications accumulated as production costs and absorbed in inventory are in conformity with generally accepted accounting principles.			
	b. Review computations of unit costs and costs credited against inventory and charged to cost of sales; update findings from tests made prior to observation of the physical count, and consider the need for further detail tests.			
	c. Review activity in the general ledger control accounts for raw materials, supplies, work in process, and finished goods inventories; investigate any significant unusual entries or fluctuations.			
	d. Review labor and overhead allocations to inventory and cost of sales; compare to actual labor and overhead costs incurred and ascertain that variances appear reasonable in amount and have been properly accounted for.			
C	4. Perform the following tests for clerical accuracy of the summarized physical inventory:			
	a. Recompute extensions of quantities and unit costs on a test basis.			
	b. Refoot accumulation of dollar subtotals on a test basis.			
	c. Refoot dollar subtotals to test total dollar amounts per the physical inventory for the major classifications (i.e., raw materials, work in process, finished goods, supplies, etc.).			
	d. Review the inventory listings for significant quantities and amounts that appear unusual.			
	e. Ascertain that the general ledger control accounts have been adjusted to include the findings of the physical inventory. (This may consist of tracing the totals per the physical to an analysis which supports journal entries, or an involved trail of tracing through the cost accounting records to the general ledger control accounts.)			
C	5. Review the pricing, extensions, and summarization of the physical inventory for items identified as slow-moving, damaged, and/or obsolete to ascertain that the items are carried at dollar amounts in conformity with the lower of cost or market principle:			
	a. Examine documentation for the proceeds of recent scrap or salvage sales.			
	b. Review client's criteria for considering items as slow-moving or obsolete and evaluate whether criteria appear reasonable and realistic. (For example, are a certain number of months used to determine when an item becomes slow-moving? Are predetermined quantities used to determine that quantities on hand are not in excess of reasonable economic need?)			

Obj.		Done By	Date	W/P Ref.
	F. Lower of Cost or Market Considerations			
C	1. On a test basis select items of raw materials and supplies inventory including some items with relatively significant carrying amounts (because of high unit costs or large quantities on hand) and:			
	a. Compare the inventory unit prices with prices per recent (prior to year end) vendors' invoices, vendor quotations, vendor price lists, and published market quotations.	____	____	____
	b. Review purchase records and production requisitions for indications of whether items may be on hand in excess quantities, slow moving, or obsolete.	____	____	____
[A] [B] C	2. On a test basis select items or classifications of finished goods and work-in-process inventories including some items with relatively significant carrying amounts (because of high unit costs or large quantities on hand) and:			
	a. Review and note current selling prices and quantities sold for the items or classifications by reference to recent sales invoices, customer orders, and published market quotations, and supplementary discussion with the client's marketing and sales executives.	____	____	____
	b. Compare inventory carrying amounts and recent selling prices for the selected finished goods items or classifications noted in terms of current relationships of sales to gross profit, selling and shipping expenses; ascertain that the carrying amounts of the selected finished goods items are not in excess of net realizable value.	____	____	____
	c. For the selected work-in-process items, ascertain their stage of completion and estimated cost to complete by reference to the cost accounting records, production reports, and inquiry of the client's production supervisors. Apply the estimated costs to complete to the selected work-in-process items and apply steps a and b above.	____	____	____
	d. Compare quantites on hand for selected items with quantities noted per recent sales invoices and customer orders; be alert that quantities on hand are not in excess of the client's requirements.	____	____	____
[A]	3. Compute the following ratios, compare them with similar ratios for prior years, and obtain explanations for unusual fluctuations:			
	a. Inventory turnover (cost of sales to inventory)			
	b. Gross profit percentage (net sales to gross profit)			
[A]	4. Compare inventory balances at the end of the year (period) with balances at the beginning of the year (period) and obtain explanations for significant and unusual fluctuations.	____	____	____
[A]	5. Relate inventory balances at the end of the year (period) to anticipated future sales.	____	____	____
	G. Other			
[A]	1. If the physical count was not taken as of the balance sheet date, analyze and reconcile the balance per the physically counted inventory to inventory per the balance sheet:			
	a. Review and analyze the general ledger control accounts for inventory from the date counted to the balance sheet date; trace additions to such sources as the purchase journal or voucher register, the cost accounting records, and charges to cost of sales.	____	____	____
	b. Compare the current activity between the count date and balance sheet date to activity of the equivalent period in the preceding year. Investigate unusual fluctuations. (SAS No. 56 [AU section 329])	____	____	____
[A]	2. Perform the following analytical procedures:			

Obj.		Done By	Date	W/P Ref.
	a. Compare inventory balances to purchases, sales, and production reports.			
	b. Analyze raw materials turnover, raw materials issued to raw materials inventory.			
	c. Review the ratio of material, labor, and overhead to total cost.			
	d. Analyze changes in gross profit.			
	e. If there were sales of scrap material, review standard cost scrap factor by the pounds processed by the published price and determine reasonableness of the scrap income.			
[A]	3. Review the sales journal and investigate the authenticity of any unusually large sales made in the period prior to the inventory count date.			
E	4. Determine whether any inventory is pledged as collateral or subject to any liens; coordinate with work on debt payable.			
D	5. Inspect open purchase order file at the balance sheet date for significant commitments that should be considered for disclosure.			
	H. Section Completion			
	1. The objectives of this audit program have been met.			

This audit program section has been completed in accordance with firm policy.

Done by

Reviewed by

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Obj.		Done By	Date	W/P Ref.

.085 X. Low Risk Inventories

Financial Statement Assertions:

1. Existence or occurrence.
2. Completeness.
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Objectives:

A. Inventory exists—To determine that the inventory exists and is the client's property. (Assertions 1 and 3)

B. Quantity and condition—To determine that the client has taken reasonable care in determining the physical quantities and identifying the condition (normal, slow moving, obsolete) of its inventory. (Assertions 2 and 4)

C. Clerical accuracy—To determine that the inventories are summarized and priced with clerical accuracy, and the records have been adjusted to the physical inventory. (Assertions 2 and 4)

D. Encumbrances identified—To determine that any encumbrances, such as pledges or liens, are identified and adequately disclosed in the financial statements. (Assertions 3, 4 and 5)

E. GAAP conformity—To determine that inventory classifications and carrying amounts are determined and presented in the financial statements in conformity with generally accepted accounting principles consistently applied (for example, assumptions about the cost flow, such as FIFO and LIFO, and lower of cost or market considerations). (Assertion 5)

NOTE: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Procedures:

A. Substantive Test Procedures

Obj.	Procedure	Done By	Date	W/P Ref.
	1. A determination has been made that there is a low level of combined inherent risk and control risk for all assertions related to inventories.	____	____	____
	2. Review the activity in the general ledger for inventory accounts for the period being audited and:			
[C]	a. Note and investigate any entries which appear unusual in source or amount.	____	____	____
	b. Compare the opening balance(s) for the period with the final closing balance(s) per the working papers and reports for the preceding period.	____	____	____

Obj.		Done By	Date	W/P Ref.
	B. Observation of the Physical Inventory			
	1. Include the following in advance planning:			
	a. Review and evaluate the adequacy of the client's instructions for making the physical count.			
	b. Consider attending the client's preparatory meetings for the physical count.			
	c. Review adequacy of audit staffing arrangements.			
	2. Tour the premises on arrival and ascertain whether the inventory arrangement is conducive to a satisfactory count; if the arrangement appears obviously unsatisfactory, recommend rearrangement.			
	3. Ascertain that items on hand which are not the property of the client are clearly identified, segregated, and excluded from the count, such as consignment, bill and hold, etc. Note such references as descriptions, quantities, serial numbers, and shipping advice numbers so that in subsequent tests of inventory summarization the auditor may determine whether the items were excluded from the physical count.			
[A]	4. Visit the shipping and receiving departments and record the control numbers for the last shipping advice and receiving report prepared prior to the physical count for subsequent tracing to accounting department records. Consider recording a few additional shipping advice and receiving report numbers for subsequent tracing as part of cut-off procedures.			
A B	5. Ascertain that receiving and shipping departments are informed that receipts after and shipments before the inventory cut-off are to be excluded from the count. Ascertain that receiving reports for items not included in the count are prominently marked "after inventory".			
B	6. Observe and note client's provision for segregation and/or clear identification of slow-moving, obsolete and/or damaged items; also be alert for such items among regular stock and if present, bring to the client's attention and note for subsequent consideration.			
[A] [B]	7. Inspect representative items of inventory and ascertain the source of their identification, description, status (work in process, finished goods, etc.), basis for count or measure (volume, weight, item tally, etc.). Inquire of both production personnel and personnel involved in the count about such items.			
[A] [B]	8. Observe and ascertain that the client's inventory instructions and procedures are being followed.			
[A] [B]	9. Ascertain that prenumbered inventory tickets or count sheets are properly controlled including:			
	a. Accounting for all tickets or sheets issued to count personnel.			
	b. Accounting for return of all tickets or sheets issued, including those unused and spoiled as well as those used, at completion of the inventory.			
[A] [B]	10. Observe the count process and make test counts ascertaining that the identifications, descriptions, and quantities are being properly noted on the inventory tickets or count sheets. If inventory count sheets are used, select some items from the floor, make test counts and trace them to the sheets; select some entries from the sheets (include some items of greater dollar value) and trace them to items on the floor.			

Obj.		Done By	Date	W/P Ref.
[C]	11. Prepare a worksheet listing some items (include some items of greater dollar value) test counted, for subsequent tracing into the client's inventory summarization. Include on the worksheet for each item the inventory ticket or count sheet number, location, description, quantity per client, quantity per your test count, and other particulars essential for subsequent tracing to the inventory summarization. Bring test count differences to the client's attention during the count so they may be resolved in a timely manner. If test count differences are not isolated, it may be necessary to request a recount of a particular area, department or product.			
B C	12. Observe that all items of inventory are clearly ticketed or marked when counted to avoid omissions and/or duplications of counts.			
B C	13. Observe whether any items are not being counted and obtain an adequate explanation for their omission.			
A B	14. Note any movement of inventory during the count; obtain an explanation for the movement and record details from the applicable authorizing documents for consideration in review of the cut-off.			
	15. Prepare a memorandum on the observation of the physical inventory including:			
	a. Comment on the physical inventory arrangements.			
	b. Implementation of the client's inventory instructions.			
	C. Summarization—Physical Quantities			
A B C	1. Relate and trace information, noted during observations of the physical, about control numbers for count tickets or count sheets used, to the client's summarization of the physical for reasonable assurance that only tickets or sheets used for the physical are included in the summarization of quantities. (Summarization of quantities may consist of the quantities per the final priced inventory or an intermediate tabulation of count tickets. In some instances the original count sheets may provide for entry of prices, extensions, and summarization of dollar amounts.)			
B C	2. Trace test counts noted during the physical to the client's summarization of quantities.			
A	3. Trace quantities confirmed by third parties to the summarization of quantities.			
B C	4. Select quantities for particular items from the summarization and trace them to the count tickets or count sheets; select quantities for particular items from the count tickets or sheets and trace them to the summarization of quantities.			
A B C	5. If the client uses perpetual inventory records and the perpetuals are to be used to determine the year-end balance, ascertain that the perpetuals were adjusted to the physical.			
B C	6. Trace notes made at the observation for slow moving, obsolete, and/or damaged items to the client's summarization of quantities and determine if they are clearly identified and priced as such.			
B C	7. Test the cut-off information noted at the observation of the physical inventory as follows:			
	a. Select the last few shipping advices used before the count to the sales register; determine that the shipments were recorded as sales and charges to cost of sales at the dates shipped.			
	b. Select a few shipping advices used after the count to the sales register and determine that the shipments were recorded as sales in the period after the date of the inventory.			
	c. Select the last few receiving reports used before the count and determine that the related liability was recorded prior to or as of the count date.			

Obj.		Done By	Date	W/P Ref.
	D. Prices and Summarization—Monetary Units			
E	1. Ascertain the methods followed concerning the flow of costs (FIFO, LIFO, moving average, etc.) and compare with working papers of the preceding year to ascertain whether the methods have been consistently applied.			
C	2. Perform the following tests for clerical accuracy of the summarized physical inventory:			
	a. Recompute extensions of quantities and unit costs on a test basis.			
	b. Refoot accumulation of dollar subtotals on a test basis.			
	c. Refoot dollar subtotals to test total dollar amounts per the physical inventory for the major classifications (i.e., raw materials, work in process, finished goods, supplies, etc.).			
	(1) Review the inventory listings for significant quantities and amounts that appear unusual.			
	(2) Ascertain that the general ledger control accounts have been adjusted to include the findings of the physical inventory. (This may consist of tracing the totals per the physical to an analysis which supports journal entries, or an involved trail of tracing through the cost accounting records to the general ledger control accounts.)			
C	3. Review the pricing, extensions, and summarization of the physical inventory for items identified as slow-moving, damaged, and/or obsolete to ascertain that the items are carried at dollar amounts in conformity with the lower of cost or market principle:			
	a. Examine documentation for the proceeds of recent scrap or salvage sales.			
	b. Review client's criteria for considering items as slow-moving or obsolete and evaluate whether criteria appear reasonable and realistic. (For example, are a certain number of months used to determine when an item becomes slow-moving? Are predetermined quantities used to determine that quantities on hand are not in excess of reasonable economic need?)			
	E. Lower of Cost or Market Considerations			
C	1. On a test basis select items of raw materials and supplies inventory including some items with relatively significant carrying amounts (because of high unit costs or large quantities on hand) and:			
	a. Compare the inventory unit prices with prices per recent (prior to year end) vendors' invoices, vendor quotations, vendor price lists, and published market quotations in quantities sufficient to support the ending balances.			
	b. Review purchase records and production requisitions for indications of whether items may be on hand in excess quantities, slow-moving, or obsolete.			
[A] [B] C	2. On a test basis, select items or classifications of finished goods and work-in-process inventories including some items with relatively significant carrying amounts (because of high unit costs or large quantities on hand) and:			
	a. Review and note current selling prices and quantities sold for the items or classifications by reference to recent sales invoices, customer orders, and published market quotations, and supplementary discussion with the client's marketing and sales executives.			

Obj.		Done By	Date	W/P Ref.
	b. Compare inventory carrying amounts and recent selling prices for the selected finished goods items or classifications noted in terms of current relationships of sales to gross profit, selling and shipping expenses; ascertain that the carrying amounts of the selected finished goods items are not in excess of net realizable value.	_____	_____	_____
	c. Compare inventory carrying amounts to cost calculation worksheets for product costing procedures.	_____	_____	_____
	d. For the selected work-in-process items, ascertain their stage of completion and estimated cost to complete by reference to the cost accounting records, production reports, and inquiry of the client's production supervisors. Apply the estimated costs to complete to the selected work-in-process items and apply steps 1 and 2 above.	_____	_____	_____
	e. Compare quantities on hand for selected items with quantities noted per recent sales invoices and customer orders; be alert that quantities on hand are not in excess of the client's requirements.	_____	_____	_____
	F. Other			
[A] [B] [C] [D] [E]	1. Perform the following analytical procedures noting and documenting unusual results:			
	a. Compare inventory balances to purchases, sales, and production reports.	_____	_____	_____
	b. Analyze raw materials turnover, raw materials issued to raw materials inventory.	_____	_____	_____
	c. Review the ratio of material, labor, and overhead to total cost.	_____	_____	_____
	d. If there were sales of scrap material, review standard cost scrap factor by the pounds processed by the published price and determine reasonableness of the scrap income.	_____	_____	_____
	e. Inventory turnover (cost of sales to inventory).	_____	_____	_____
	f. Gross profit percentage (net sales to gross profit).	_____	_____	_____
	g. Beginning inventory to ending inventory.	_____	_____	_____
	h. Net sales to inventory.	_____	_____	_____
	i. Days inventory (inventory by cost of sales).	_____	_____	_____
	j. Current liabilities to inventory.	_____	_____	_____
	G. Section Completion			
	1. The objectives of this audit program have been met.	_____	_____	_____

This audit program section has been completed in accordance with firm policy.

_______________________________________ _____ _____ _____

Done by

_______________________________________ _____ _____ _____

Reviewed by

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Obj.		Done By	Date	W/P Ref.

.090 XI. Property and Equipment, and Related Depreciation

Financial Statement Assertions:

1. Existence or occurrence.
2. Completeness.
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Objectives:

A. Property exists—To determine that the property exists and is owned by the entity. (Assertion 1)

B. Additions appropriate—To determine that additions to property are authentic, recorded at cost, and properly distinguished from maintenance and repairs expense. (Assertions 1, 2 and 3)

C. Retirements recorded—To determine that retirements of property together with the proceeds from salvage and related cost to remove are properly recognized. (Assertions 1, 2 and 4)

D. Depreciation appropriate—To determine that a proper amount of depreciation expense is allocated to the period based on the asset cost, estimated life and salvage, and use of acceptable methods consistently applied, and adequately presented in the financial statements. (Assertions 4 and 5)

E. Recoverable value—To determine that the net carrying value as presented in the financial statements is expected to be recoverable through the ordinary course of business. (Assertion 4)

F. Encumbrances identified—To determine that any encumbrances and liens are identified and adequately disclosed in the financial statements. (Assertion 5)

G. Proper classification—To determine that significant amounts of idle property and equipment are properly stated, classified and described. (Assertion 5)

H. Proper disclosure—To determine that significant amounts of fully depreciated assets are considered for disclosure. (Assertion 5)

NOTE: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Procedures:

A. Substantive Test Procedures

Obj.		Done By	Date	W/P Ref.
	1. Obtain (or update) an understanding of the client's policies concerning capitalization of assets and related depreciation methods and depreciable lives.	____	____	____
	2. Consider a tour of the client's facilities for new staff assigned to the engagement, or for the entire audit team if significant changes have occurred.	____	____	____
	3. Consider the extent to which it may be practicable to perform substantive tests prior to the balance sheet date.	____	____	____
[A] [B] [C] [D]	4. Obtain or prepare the following schedules:			
	a. Summary schedule of property, plant and equipment, and related depreciation (by major asset classification) including the following:			
	(1) Beginning and ending asset balances at cost.	____	____	____
	(2) Asset additions at cost.	____	____	____
	(3) Asset retirements and dispositions.	____	____	____
	(4) Other changes.	____	____	____
	(5) Depreciation method and life.	____	____	____
	(6) Beginning and ending balances of the allowances for depreciation.	____	____	____
	(7) Additions to the allowances for depreciation accompanied by an analysis of amounts expensed, absorbed in inventory, and capitalized.	____	____	____
	(8) Reductions of the allowances for depreciation for retirements and dispositions.	____	____	____
	b. Additions at cost showing the description, date acquired, transaction reference (purchase order number, check number, work order number, etc.), estimated useful life, and cost for all additions of $— or over. (Also see step 14 below.)	____	____	____
	c. Retirements and dispositions showing the description, date of acquisition, date of retirement or disposition, cost, accumulated depreciation, net carrying value, proceeds of disposition, and gain or loss on disposition. (Also see step 14 below.)	____	____	____
	d. Analysis of maintenance expense showing each transaction of $— or greater (or all transactions) for the year or period.	____	____	____
[A] [B] [C]	5. Trace opening balances per the summary schedules to closing balances per the prior year's working papers.	____	____	____
B C	6. Trace amounts per the summary schedule to the general ledger, the detailed asset records, and to the schedules of additions, and retirements and dispositions; recompute the footings and crossfootings of the schedules.	____	____	____
A B [C] F	7. Perform the following tests of selected additions:			
	a. Determine the addition has been authorized by reference to such sources as minutes of the meetings of the Board of Directors or Finance Committee and/or capital asset budgets reviewed by the Board of Directors or Finance Committee or by evidence of approval by appropriate, responsible personnel, in accordance with prescribed policies.	____	____	____
	b. Examine such supporting documents as purchase contracts, paid checks, vendors' invoices, purchase orders, receiving reports, work orders, engineers' reports, etc.	____	____	____
	c. Trace transactions to appropriate entries in the detailed records.	____	____	____

Obj.		Done By	Date	W/P Ref.
	d. For construction in progress examine supporting work orders, documentation in support of costs incurred such as contractors' invoices, reports and correspondence from engineers and/or architects regarding completion and trace transfers from the construction in progress accounts to other property accounts.			
	e. Physically inspect selected (or all) major additions.			
	f. Inquire about related dispositions.			
	g. Determine whether additions conform with the company's capitalization policy.			
	h. Determine that installment purchases, if any, are properly recorded.			
	i. By reference to purchase contracts and contractors billings identify related liabilities to be recorded in connection with debt or other payables.			
A C [D]	8. Perform the following tests of dispositions:			
	a. Determine disposition has been properly authorized.			
	b. Examine such supporting documents as bills of sale, contracts, delivery memoranda, etc.			
	c. Trace retirements to the detailed property records.			
	d. Determine that deductions from the asset accounts and related accumulated depreciation are correct.			
	e. Determine that gain or loss on disposition has been correctly classified and recorded.			
A C G H	9. For fully depreciated assets, determine whether the assets are still used and not retired from service.			
A C G H	10. Determine that assets retired from service, if material, have been removed from the property, plant and equipment accounts and related accumulated depreciation accounts, and are carried at amounts which are not in excess of realizable value.			
A D G H	11. Review lease agreements for new leases and determine whether leased assets which should be capitalized have been capitalized, and that related depreciation is being determined using an appropriate method and life.			
D [E]	12. Review provisions for depreciation and amortization, and:			
	a. Determine whether the methods and depreciable lives used in the current year are consistent with the preceding year and are reasonable.			
	b. Test computations of depreciation and amortization.			
	c. Determine that amounts of depreciation capitalized in construction in progress are reasonable and appropriate.			
	d. Ascertain that obsolescence, if any, is being properly recognized by adjustments of depreciable lives.			
	e. Trace additions to the depreciation allowances to the applicable general ledger expense accounts.			
B	13. Review maintenance expense and examine supporting documentation for selected transactions to determine that the amounts have been properly classified.			
B C	14. Obtain or prepare and test an analysis of qualified additions and early dispositions of qualified property in a format which provides for determination of the investment tax credit. (This may be incorporated into schedules for additions and dispositions.)			
[A] [D]	15. Review the following relationships for the current and preceding year and obtain explanations for significant fluctuations (SAS No. 56 [AU section 329]):			

Obj.		Done By	Date	W/P Ref.
	a. Dispositions of property and equipment to replacements.			
	b. Accumulated depreciation to plant and equipment balances at cost			
	c. Current year depreciation and amortization to plant and equipment balances at cost.			
	B. Section Completion			
	1. The objectives of this audit program have been met.			

This audit program section has been completed in accordance with firm policy.

Done by

Reviewed by

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Obj.		Done By	Date	W/P Ref.

.095 XII. Low Risk Property and Equipment, and Related Depreciation and Amortization

Financial Statement Assertions:

1. Existence or occurrence.
2. Completeness.
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Objectives:

A. Property exists—To determine that the property exists and is owned by the entity. (Assertion 1)

B. Additions appropriate—To determine that additions to property are authentic, recorded at cost, and properly distinguished from maintenance and repairs expense. (Assertions 1, 2 and 3)

C. Retirements recorded—To determine that retirements of property together with the proceeds from salvage and related cost to remove are properly recognized. (Assertions 1, 2 and 4)

D. Depreciation appropriate—To determine that a proper amount of depreciation expense is allocated to the period based on the asset cost, estimated life and salvage, and use of acceptable methods consistently applied, and adequately presented in the financial statements. (Assertions 4 and 5)

E. Recoverable value—To determine that the net carrying value as presented in the financial statements is expected to be recoverable through the ordinary course of business. (Assertion 4)

F. Encumbrances identified—To determine that any encumbrances and liens are identified and adequately disclosed in the financial statements. (Assertions 3 and 5)

G. Proper classification—To determine that significant amounts of idle property and equipment are properly stated, classified, and described. (Assertion 5)

Obj.		Done By	Date	W/P Ref.
	H. Proper disclosure—To determine that significant amounts of fully depreciated assets are considered for disclosure. (Assertion 5)			
	I. GAAP conformity—To determine that the financial statement presentation and disclosure of plant, property, and equipment and related depreciation is in conformity with generally accepted accounting principles consistently applied. (Assertion 5)			
	NOTE: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.			
	Procedures:			
	A. Substantive Test Procedures			
	1. A determination has been made that there is a low level of combined inherent risk and control risk for all assertions related to property.	____	____	____
	2. Obtain (or update) an understanding of the client's policies concerning capitalization of assets and related depreciation methods and depreciable lives (book and tax).	____	____	____
[B] [C] [D]	3. Review the activity in the general ledger for property and equipment and the related depreciation accounts, as well as repairs and maintenance for the period being audited and:			
	a. Note and investigate any entries which appear unusual in source or amount.	____	____	____
	b. Compare the opening balance(s) for the period with the final closing balance(s) per the working papers and reports for the preceding period.	____	____	____
[A] [B] [C] [D] [E] [F] [G] [H] [I]	4. Obtain or prepare the following schedules:			
	a. Summary schedule of property, plant, and equipment, and related depreciation (by major asset classification) including the following:			
	(1) Beginning and ending asset balances at cost.	____	____	____
	(2) Asset additions at cost.	____	____	____
	(3) Asset retirements and dispositions.	____	____	____
	(4) Insurance coverage limits.	____	____	____
	(5) Other changes.	____	____	____
	(6) Depreciation method and life.	____	____	____
	(7) Beginning and ending balances of the allowance for depreciation.	____	____	____
	(8) Additions to the allowances for depreciation accompanied by an analysis of amounts expensed, absorbed in inventory, and capitalized.	____	____	____
	(9) Reductions of the allowances for depreciation for retirements and dispositions.	____	____	____
	(10) Dollar value of amounts owed on property.	____	____	____
	b. Additions at cost showing the description, date acquired, transaction reference (purchase order number, check number, work order number, etc.), estimated useful life, and cost for all additions of $__ or over.	____	____	____

Obj.		Done By	Date	W/P Ref.
	c. Retirements and dispositions showing the description, date of acquisition, date of retirement or disposition, cost, accumulated depreciation, net carrying value, proceeds of disposition, and gain or loss on disposition.	____	____	____
	d. Analysis of maintenance expense showing each transaction of $__ or greater (or all transactions) for the year or period.	____	____	____
[A] [B] [C]	5. Trace opening balances per the summary schedules to closing balances per the prior year's working papers.	____	____	____
[A] [B] [C] [D] [F] [G] [H]	6. Review the following relationships for the current and preceding year and obtain explanations for significant fluctuations (SAS No. 56 [AU section 329]):			
	a. Dispositions of property and equipment to replacements (dollar value as well as number of units).	____	____	____
	b. Accumulated depreciation to plant and equipment balances at cost.	____	____	____
	c. Current year depreciation and amortization to plant and equipment balances at cost.	____	____	____
	d. Additions with budgeted amounts.	____	____	____
	e. Gains and losses on disposals.	____	____	____
	f. Amortization/depreciation expense to net sales.	____	____	____
	g. Maintenance expense to prior year expense and budgeted amount.	____	____	____
	h. Value of property compared to amounts owed on property.	____	____	____
	B. Section Completion			
	1. The objectives of this audit program have been met.	____	____	____

This audit program section has been completed in accordance with firm policy.

______________________ Done by	____	____	____
______________________ Reviewed by	____	____	____

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Obj.		Done By	Date	W/P Ref.

.100 XIII. Prepaid Expenses, Deferred Charges, Intangibles, and Other Assets

Financial Statement Assertions:

1. Existence or occurrence.
2. Completeness.
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Objectives:

A. Properly recorded—To determine that the balances represent costs which are properly allocable to future periods in conformity with generally accepted accounting principles. (Assertions 1, 2, 3 and 4)

B. Additions supported—To determine that additions are adequately supported. (Assertions 1, 2, 3 and 5)

C. Amortization appropriate—To determine that amortization is determined by a rational and systematic method consistently applied. (Assertions 4 and 5)

D. Impairment recognized—To determine that any permanent impairment of balance is recognized by write-downs charged to operations. (Assertions 1, 2, 4 and 5)

E. Proper classification—To determine that balances and related expenses are properly described and classified in the financial statements. (Assertion 5)

F. Contingencies disclosed—To determine whether there are uninsured risks that should be considered for disclosure (see FASB Statement No. 5, paragraph 103 [AC section C59, footnote 5]). (Assertion 5)

NOTE: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e. [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Procedures:

A. Substantive Test Procedures

Obj.	Procedure	Done By	Date	W/P Ref.
A B C E	1. Obtain or prepare an analysis for each significant classification of prepaid expenses, deferred charges, other assets or intangibles. The analysis should include adequate description of significant components and the following:			
	a. Balance at the beginning of the year (or period).	____	____	____
	b. Additions at cost.	____	____	____
	c. Deductions charged to expense, and to other accounts.	____	____	____
	d. Balance at the end of the year (or period).	____	____	____

Obj.		Done By	Date	W/P Ref.
	2. Foot analysis and trace totals to general ledger; trace opening balance to the audit working papers for the preceding year (or period).			
A B [C] D E	3. Examine supporting documents for material charges during the year.			
[A] C [D]	4. Review and recompute amortization; determine that the amortization period is reasonable.			
A C [D]	5. Determine that the carrying amount of the item does not exceed amounts properly allocable to future periods.			
C	6. Trace amounts amortized during the period to the related general ledger expense accounts.			
A	7. Confirm significant deposits and assets held by others.			
A F	8. Obtain or prepare an analysis of prepaid insurance and insurance expenses (including life insurance premiums); perform the following additional tests:			
	a. Examine all or selected policies noting identity of insurer, descriptions and amounts of coverage, premiums, and period covered; compare particulars with the analysis.			
	b. Ascertain by review of the policy and related billing advices for the insurance premiums whether the premiums are being financed and/or the policy or cash surrender value has been pledged; determine that related liabilities and finance cost have been properly recorded.			
	c. Obtain confirmation of cash surrender values; consider confirmation of policies especially if premium financing is involved to determine that payments are current and coverage is still in force.			
	d. Ascertain whether all significant insurable risks have been considered.			
	e. Recompute amortization and trace amounts to the applicable expense accounts.			
A	9. For property taxes, where significant, obtain or prepare an analysis which relates both prepayments and accruals as of the beginning and end of the period with tax expense. Examine tax billings and determine whether the timing of the period covered by the tax and the payment due dates result in prepayment or an accrual as of the balance sheet date. Trace charges to expense to the proper expense account.			
A B C	10. For intangible assets:			
	a. Trace authorization for major transactions to minutes of Board of Directors meetings.			
	b. Examine supporting documents.			
	c. Ascertain whether amortization has been properly computed in conformity with generally accepted accounting principles, and trace charges to related expense accounts.			
A D	11. Determine that there has been no permanent impairment of value for prepaid expenses, deferred charges, intangible assets, etc.			
E	12. Determine that balances are properly classified in the balance sheet (current v. non-current, etc.)			
F	13. Determine that there have been no uninsured events which would affect the value of other assets.			

Obj.		Done By	Date	W/P Ref.
	B. Section Completion			
	1. The objectives of this audit program have been met.	____	____	____

This audit program section has been completed in accordance with firm policy.

______________________________ ____ ____ ____
Done by

______________________________ ____ ____ ____
Reviewed by

The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

Obj.		Done By	Date	W/P Ref.

.105 XIV. Low Risk Prepaid Expenses, Deferred Charges, Intangibles, and Other Assets

Financial Statement Assertions:

1. Existence or occurrence.
2. Completeness.
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Objectives:

A. Properly recorded—To determine that the balances represent costs which are properly allocable to future periods in conformity with generally accepted accounting principles. (Assertions 1, 2, 3 and 4)

B. Additions supported—To determine that additions are adequately documented. (Assertions 1, 2, 3 and 5)

C. Amortization appropriate—To determine that amortization is determined by a rational and systematic method consistently applied. (Assertions 4 and 5)

D. Impairment recognized—To determine that any permanent impairment of balances is recognized by write-downs charged to operations. (Assertions 1, 2, 4 and 5)

E. Proper classification—To determine that balances and related expenses are properly described and classified in the financial statements. (Assertion 5)

F. Contingencies disclosed—To determine whether there are uninsured risks that should be considered for disclosure (FASB Statement No. 5, *Accounting for Contingencies*, paragraph 103 [AC section C59, footnote 5]). (Assertion 5)

G. GAAP conformity—To determine that the financial statement presentation and disclosure of other assets is in conformity with generally accepted accounting principles consistently applied. (Assertion 5)

NOTE: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objectives column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Procedures:

A. Substantive Test Procedures

Obj.	Procedure	Done By	Date	W/P Ref.
	1. A determination has been made that there is a low level of combined inherent risk and control risk for all assertions related to other assets.	_____	_____	_____
[A] [E]	2. Review the activity in the general ledger for other asset accounts for the period being audited and:			

Obj.		Done By	Date	W/P Ref.
	a. Note and investigate any entries which appear unusual in source or amount.	____	____	____
	b. Compare the opening balance(s) for the period with the final closing balance(s) per the working papers and reports for the preceding period.	____	____	____
A B C E G	3. Obtain or prepare an analysis for each significant classification of prepaid expenses, deferred charges, other assets or intangibles. The analysis should include adequate description of significant components and the following:			
	a. Balance at the beginning of the year (or period).	____	____	____
	b. Additions at cost.	____	____	____
	c. Deductions charged to expense, and to other accounts.	____	____	____
	d. Balance at the end of the year (or period).	____	____	____
	e. Amoritization policy.	____	____	____
	4. Foot analysis and trace totals to general ledger; trace opening balance to the audit working papers for the preceding year (or period).	____	____	____
[A] C [D]	5. Review and recompute amortization; determine that the amortization period is reasonable.	____	____	____
[B][C][E]	6. Perform the following analytical procedures and investigate unusual results:			
	a. Budgeted amounts to actual.	____	____	____
	b. Prior period to current period.	____	____	____
	c. Expense for amortization to prior year expense.	____	____	____
A C [D]	7. Determine that the carrying amount of the item does not exceed amounts properly allocable to future periods.	____	____	____
A D G	8. Determine that there has been no permanent impairment of value for prepaid expenses, deferred charges, intangible assets, etc.	____	____	____
E	9. Determine that balances are properly classified in the balance sheet (current v. noncurrent, etc.).	____	____	____
F	10. Determine that there have been no uninsured events which would affect the value of other assets.	____	____	____
A D F	11. Obtain or prepare an analysis of prepaid insurance with an emphasis on amounts and types of risks covered.	____	____	____
	B. Section Completion			
	1. The objectives of this audit program have been met.	____	____	____

This audit program section has been completed in accordance with firm policy.

Done by	____	____	____
Reviewed by	____	____	____

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Obj.		Done By	Date	W/P Ref.

.110 XV. Accounts Payable

Financial Statement Assertions:

1. Existence or occurrence.
2. Completeness.
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Objectives:

A. Payables exist—To determine that accounts payable represent authorized current obligations. (Assertions 1 and 2)

B. Proper classification—To determine that amounts included in accounts payable are properly classified. (Assertion 5)

C. Obligations complete—To determine that accounts payable include all significant current obligations. (Assertions 2, 3 and 4)

D. Proper disclosure—To determine that adequate disclosure has been made of any pledged assets. (Assertion 5)

NOTE: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e. [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Procedures:

A. Substantive Test Procedures

1. Were the following items considered:

   a. Results of the tests of controls as they relate to purchases, accounts payable, and disbursements. ____ ____ ____

   b. Results of tests of controls as it relates to payroll regarding liability for withheld payroll taxes. ____ ____ ____

   c. Whether to request positive confirmation from vendors and, if so, when and to what extent. ____ ____ ____

   NOTE: Some auditors send confirmations to major vendors to obtain independent outside evidence that all liabilities have been recorded. Other auditors believe that evidential matter can be obtained more efficiently through other procedures.

   d. Potential efficiencies to be gained from coordination of accounts payable work with substantive tests of inventory when the physical is taken at the balance sheet date. (For example, tests of cut off, and using vouchers obtained from client's files in substantiating recent inventory prices as well as accounts payable work.) ____ ____ ____

Obj.		Done By	Date	W/P Ref.
A B C D	2. Obtain or prepare a schedule of accounts payable as of the balance sheet date.			
	a. Foot schedule and trace totals to the general ledger.	____	____	____
	b. Trace selected individual accounts to accounts payable subsidiary ledger and vice versa.	____	____	____
	c. Discuss with client old or disputed payables.	____	____	____
	d. Investigate debit balances and, if significant, consider requesting positive confirmations and propose reclassification of the amounts.	____	____	____
	e. Ascertain by review of minutes, agreements and by inquiry whether any assets are pledged to collateralize payables.	____	____	____
	f. Identify intercompany accounts and:			
	(1) Arrange to have balances traced to corresponding receivables in the affiliate's books if affiliate is being currently audited by the firm.	____	____	____
	(2) Obtain confirmation from the affiliate.	____	____	____
	(3) Investigate and reconcile differences.	____	____	____
A B [C] D	3. Consider confirmation procedures such as the following:			
	a. Obtain and review a list of major vendors, or identify major vendors by reviewing voucher registers or subsidiary accounts payable records.	____	____	____
	b. Request vendors to provide a statement of the account balance as of the date selected (ordinarily, the physical inventory date and/or balance sheet date).	____	____	____
	c. Investigate and reconcile differences.	____	____	____
A B [D]	4. Confirm balances due to officers and employees; ascertain business purpose of the transactions and, if significant, trace to authorization in the minutes of the Board of Directors meetings.	____	____	____
A C	5. Test selected unconfirmed balances by examination of vouchers, invoices, and receiving reports.	____	____	____
A C	6. Perform a search for unrecorded liabilities for the period after the close of the year or period under audit to a date on or near the conclusion of fieldwork, including the following sources, and schedule findings to show effect of the potential adjustment on operations or financial position:			
	a. Examine files of receiving reports unmatched with vendors' invoices, searching for significant items received on or before the balance sheet date. Use this information to test client's schedule of goods received but not billed. (If vendors' invoices are not available, refer to the purchase order for prices.)	____	____	____
	b. Inspect files of unprocessed invoices and vendors' statements for unrecorded liabilities.	____	____	____
	c. Review the cash disbursements journal for disbursements after the balance sheet date; obtain and examine supporting detail for each disbursement of $________ and over and determine that accounts payable at the balance sheet date were properly recorded.	____	____	____
	d. Review the voucher register for transactions recorded after the balance sheet date; obtain and examine supporting detail for each transaction of $________ and over to identify items that should have been recorded at the balance sheet date and were not.	____	____	____
	e. Inquire of responsible client staff about their knowledge of additional sources of unprocessed invoices, unrecorded commitments, or contingent liabilities.	____	____	____
A B C	7. Liabilities for payroll taxes withheld:			

Obj.		Done By	Date	W/P Ref.
	a. Trace liabilities to payments made subsequent to the balance sheet date; examine the payroll tax deposit receipts.	____	____	____
	b. Compare liability to accrued payroll taxes for reasonableness.	____	____	____
	c. Trace liabilities to summaries of the applicable payroll registers.	____	____	____

B. Section Completion

1. The objectives of this audit program have been met. ____ ____ ____

This audit program section has been completed in accordance with firm policy.

______________________________ ____ ____ ____
Done by

______________________________ ____ ____ ____
Reviewed by

The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

Obj.		Done By	Date	W/P Ref.

.115 XVI. Low Risk Accounts Payable

Financial Statement Assertions:

1. Existence or occurrence.
2. Completeness.
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Objectives:

A. Payables exist — To determine that accounts payable represent authorized current obligations. (Assertions 1, 2 and 3)

B. Proper classification — To determine that amounts included in accounts payable are properly classified. (Assertion 5)

C. Obligations complete — To determine that accounts payable include all significant current obligations. (Assertions 2, 3 and 4)

D. Proper disclosure — To determine that adequate disclosure has been made of any pledged assets. (Assertion 5)

E. GAAP conformity — To determine that presentation and disclosure of accounts payable is in conformity with generally accepted accounting principles consistently applied. (Assertion 5)

NOTE: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Procedures:

A. Substantive Test Procedures

Obj.	Procedure	Done By	Date	W/P Ref.
	1. A determination has been made that there is a low level of combined inherent risk and control risk for all assertions related to accounts payable.	____	____	____
[B]	2. Review the activity in the general ledger for accounts payable and cash disbursements for the period being audited and:			
	a. Note and investigate any entries which appear unusual in source or amount.	____	____	____
	b. Compare the opening balance(s) for the period with the final closing balance(s) per the working papers and reports for the preceding period.	____	____	____
ABCDE	3. Obtain or prepare a schedule of accounts payable as of the balance sheet date.			
	a. Trace ending totals to the accounts payable subsidiary ledger and the general ledger. Trace opening balances to the prior period working papers.	____	____	____

Obj.		Done By	Date	W/P Ref.
	b. Discuss with client old or disputed payables.			
	c. Investigate debit balances and, if significant, propose reclassification of the amounts.			
	d. Identify intercompany accounts and:			
	(1) Arrange to have balances traced to corresponding receivables in the affiliate's books if affiliate is being currently audited by the firm.			
	(2) Investigate and reconcile differences.			
[A] [B] [C] [E]	4. Using the schedule prepared in 3 above, perform the following analytical procedures:			
	a. Compare prior year amounts to current year.			
	b. Compare budgeted amounts to current years amounts.			
	c. Accounts payable to net sales.			
	d. Days payable in cost of sales.			
	e. Acid-test ratio (current assets − [inventory + prepaids]/current liabilities).			
	f. Accounts payable to total disbursements.			
A B C E	5. Ascertain whether any accounts payable are owed to employees or related parties such as officers, directors, shareholders and affiliates, etc. and:			
	a. Obtain an understanding of the purpose for the transactions which resulted in balances.			
	b. Ascertain that transactions were properly authorized.			
	c. Determine if any notes repaid prior to the balance sheet date have since been renewed.			
	d. Consider need for disclosure of significant related party transactions.			
A C E	6. Perform a search for unrecorded liabilities for the period after the close of the year or period under audit to a date on or near the conclusion of fieldwork.			
	B. Section Completion			
	1. The objectives of this audit program have been met.			

This audit program section has been completed in accordance with firm policy.

Done by ______________________

Reviewed by ______________________

The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

Obj.		Done By	Date	W/P Ref.

.120 XVII. Accrued Liabilities Other Than Income Taxes

Financial Statement Assertions:

1. Existence or occurrence.
2. Completeness.
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Objectives:

A. Liabilities complete—To determine that expense accounts include costs and expenses applicable to the period. (Assertions 1, 2 and 5)

B. GAAP conformity—To determine that all contingencies and estimated future expenses that should be accrued in the period have been accrued, classified, and described in accordance with generally accepted accounting principles consistently applied. (Assertions 1, 2, 3, 4 and 5)

NOTE: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Procedures:

A. Substantive Test Procedures

Obj.	Procedure	Done By	Date	W/P Ref.
	1. Were the following items considered:			
	a. Results of the tests of controls as it relates to purchases, payables and disbursements, and payroll.	____	____	____
	b. Coordination of work with review and comparisons of costs and expenses incurred for the current year (period) with the preceding year (period) and with budgeted amounts.	____	____	____
[A]	2. Obtain or prepare analysis of accrued liability accounts.	____	____	____
[A]	3. Examine documents or working papers supporting amounts accrued and:			
	a. Determine the basis and method of accrual.	____	____	____
	b. Recompute amounts provided.	____	____	____
	c. Review accrual for reasonableness.	____	____	____
A B	4. Trace amounts accrued during the year to related expense accounts.	____	____	____
A B	5. Compare accrual to subsequent payments, where possible, to determine reasonableness.	____	____	____
A B	6. Determine if any other accruals are required as a result of the search for unrecorded liabilities.	____	____	____

Obj.		Done By	Date	W/P Ref.
[A] [B]	7. Investigate and explain any large fluctuations in accruals between the current and the preceding period (SAS No. 56 [AU section 329]).	____	____	____
A B	8. For vacation accruals:			
	a. Examine union contracts and/or personnel manuals to determine vacation policies.	____	____	____
	b. Test the client's computation of accrued vacation pay. (In some cases this might be a detailed calculation; in other cases, it may be more in the nature of an overall estimate. (SAS No. 57 [AU section 342]))	____	____	____
A B	9. For accrued payroll taxes:			
	a. Compare accruals as of the balance sheet date to subsequent payments and determine that amounts were accrued in the proper period.	____	____	____
	b. Consider reconciling wages per the payroll tax returns to the payroll registers.	____	____	____
	B. Section Completion			
	1. The objectives of this audit program have been met.	____	____	____

This audit program section has been completed in accordance with firm policy.

Done by	____	____	____
Reviewed by	____	____	____

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Obj.		Done By	Date	W/P Ref.

.125 XVIII. Low Risk Accrued Liabilities Other Than Income Taxes

Financial Statement Assertions:

1. Existence or occurrence.
2. Completeness.
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Objectives:

A. Liabilities complete—To determine that expense accounts include costs and expenses applicable to the period. (Assertions 1, 2 and 5)

B. GAAP conformity—To determine that all contingencies and estimated future expenses that should be accrued in the period have been accrued, classified, and described in accordance with generally accepted accounting principles consistently applied. (Assertions 1, 2, 3, 4 and 5)

NOTE: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Procedures:

A. Substantive Test Procedures

Obj.	Procedure	Done By	Date	W/P Ref.
	1. A determination has been made that there is a low level of combined inherent risk and control risk for all assertions related to accured liabilities.	____	____	____
[A]	2. Review the activity in the general ledger for accrued liabilities for the period being audited and:			
	a. Note and investigate any entries which appear unusual in source or amount.	____	____	____
	b. Compare the opening balance(s) for the period with the final closing balance(s) per the working papers and reports for the preceding period.	____	____	____
[A]	3. Obtain or prepare analysis of accrued liability accounts and agree ending totals to the general ledger and beginning totals to prior year's workpapers.	____	____	____
[A]	4. Examine documents or working papers supporting amounts accrued and:			
	a. Determine the basis and method of accrual.	____	____	____
	b. Review accrual for reasonableness.	____	____	____
A B	5. Trace amounts accrued during the year to related expense accounts.	____	____	____

Obj.		Done By	Date	W/P Ref.
A B	6. Determine if any other accruals are required as a result of the search for unrecorded liabilities and contingencies.	____	____	____
[A] [B]	7. Investigate and explain any large fluctuations in accruals between the current and the preceding period (SAS No. 56 [AU section 329]).	____	____	____
A B	8. For vacation accruals:			
	a. Examine union contracts and/or personnel manuals to determine vacation policies.	____	____	____
	b. Test the client's computation of accrued vacation pay. (In some cases this might be a detailed calculation; in other cases, it may be more in the nature of an overall estimate.) (SAS No. 57 [AU section 342])	____	____	____
A B	9. For accrued payroll taxes:			
	a. Compare accruals as of the balance sheet date to subsequent payments and determine that amounts were accrued in the proper period.	____	____	____
	b. Consider reconciling wages and taxes per the payroll tax returns to the payroll registers.	____	____	____
A B	10. Perform the following analytical procedures:			
	a. Compare prior year amounts with the current period.	____	____	____
	b. Compare budgeted amounts with the current period.	____	____	____
	c. Compare amounts expensed with the amounts accrued for the current period.	____	____	____
	B. Section Completion			
	1. The objectives of this audit program have been met.	____	____	____

This audit program section has been completed in accordance with firm policy.

______________________ Done by	____	____	____
______________________ Reviewed by	____	____	____

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Obj.		Done By	Date	W/P Ref.

.130 XIX. Income Taxes Accrued and Provided

Financial Statement Assertions:

1. Existence or occurrence.
2. Completeness.
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Objectives:

A. Amount reasonable—To determine that the provision for income taxes is reasonable. (Assertions 1, 2, 3 and 4)

B. Amount comparable to amount to be paid—To determine that the liability for accrued income taxes is adequate and not excessive in relation to amounts reasonably expected to be payable (Assertions 3 and 4)

C. Temporary differences recognized—To determine that deferred income taxes represent the effect of temporary differences. (Assertions 1, 2 and 4)

D. Proper classification—To determine that income tax provisions, accruals and deferrals are properly described and classified in conformity with generally accepted accounting principles consistently applied. (Assertion 5)

NOTE: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Procedures:

A. Substantive Test Procedures

Obj.	Procedure	Done By	Date	W/P Ref.
A B C [D]	1. Obtain or prepare analyses of the various current and deferred income tax liabilities and assets and related provisions showing:			
	a. Balances at the beginning of the year (period)	____	____	____
	b. Amounts provided	____	____	____
	c. Refunds received	____	____	____
	d. Payments made, indicating date and nature	____	____	____
	e. Balances at the end of the year (period)	____	____	____
A B	2. Trace payments to cash books and general ledger; examine cancelled checks for evidence of timely payment.	____	____	____
A B	3. Compare payments and refunds to copies of income tax returns.	____	____	____

Obj.		Done By	Date	W/P Ref.
A B C	4. Ascertain latest year that income tax returns have been examined and which periods, if any, are being contested. Examine recent Revenue Agent Reports; determine that adequate consideration has been given to items challenged in the past.	____	____	____
A D	5. Determine that any assessments for tax deficiencies and related interest expenses have been properly recorded.	____	____	____
B C	6. Identify temporary differences between taxable income and pretax financial income for the period, and between the tax bases of assets and liabilities and their reported amounts on the financial statements.	____	____	____
A B C	7. Compute, or obtain and test the client's computation of, deferred tax assets and liabilities to determine conformance with FASB Statement No. 109 (AC I27).			
B	8. For deferred tax assets, determine the likelihood that all or part of the recorded amount will not be realized.	____	____	____
B	9. If it is determined that it is more likely than not that all or part of the deferred tax asset will not be realized, evaluate the adequacy of the valuation allowance account by performing the following:			
	a. Review and test the process used by management to develop the estimate or develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate.	____	____	____
	b. Determine whether any subsequent events or transactions have occurred prior to the completion of fieldwork that could affect the adequacy of the valuation allowance.	____	____	____
	10. Update carryforward analyses of the composition of all income tax liability accounts.	____	____	____
C	11. Update carryforward analyses of the composition of all deferred tax accounts.	____	____	____
	B. Section Completion			
	1. The objectives of this audit program have been met.	____	____	____

This audit program section has been completed in accordance with firm policy.

_______________________________________ ____ ____ ____

Done by

_______________________________________ ____ ____ ____

Reviewed by

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Obj.		Done By	Date	W/P Ref.

.135 XX. Low Risk Income Taxes Accrued and Provided

Financial Statement Assertions:

1. Existence or occurrence.
2. Completeness.
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Objectives:

A. Amount reasonable—To determine that the provision for income taxes is reasonable. (Assertions 1, 2, 3 and 4)

B. Amount comparable to amount to be paid—To determine that the liability for accrued income taxes is adequate and not excessive in relation to amounts calculated. (Assertions 3 and 4)

C. Temporary differences recognized—To determine that deferred income taxes represent the effect of temporary differences. (Assertions 1, 2 and 4)

D. Proper classification—To determine that income tax provisions, accruals, deferrals and carryforwards are properly classified. (Assertion 5)

E. GAAP conformity—To determine that the financial statement presentation and disclosure of income taxes is in conformity with generally accepted accounting principles consistently applied. (Assertion 5)

NOTE: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Procedures:

A. Substantive Test Procedures

Obj.	Procedure	Done By	Date	W/P Ref.
	1. A determination has been made that there is a low level of combined inherent risk and control risk for all assertions related to income taxes.	____	____	____
[A][B][D]	2. Review the activity in the general ledger for the income tax account(s) for the period being audited and:			
	a. Note and investigate any entries which appear unusual in source or amount.	____	____	____
	b. Compare the opening balance(s) for the period with the final closing balance(s) per the working papers and reports for the preceding period.	____	____	____
A B C [D][E]	3. Obtain or prepare analyses of the various current and deferred income tax liabilities and assets and related provisions showing:			

Obj.		Done By	Date	W/P Ref.
	a. Balances at the beginning of the year (period).			
	b. Amounts provided.			
	c. Refunds received.			
	d. Payments made, indicating date and nature.			
	e. Balances at the end of the year (period).			
A B	4. Trace payments to the general ledger.			
A B	5. Compare payments and refunds to copies of income tax returns.			
A B C	6. Ascertain for the latest year that income tax returns have been examined and which periods, if any, are being contested. Examine recent Revenue Agent Reports; determine that adequate consideration has been given to items challenged in the past.			
A D E	7. Determine that any assessments for tax deficiencies and related interest expenses have been properly recorded.			
B C	8. Identify temporary differences between taxable income and pretax financial income for the period, and between the tax bases of assets and liabilities and their reported amounts on the financial statements.			
A B C	9. Compute, or obtain and test the client's computation of, deferred tax assets and liabilities to determine conformance with FASB Statement No. 109 (AC I27).			
B	10. For deferred tax assets, determine the likelihood that all or part of the recorded amount will not be realized.			
B	11. If it is determined that it is more likely than not that all or part of the deferred tax asset will not be realized, evaluate the adequacy of the valuation allowance account by performing the following:			
	a. Review and test the process used by management to develop the estimate or develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate.			
	b. Determine whether any subsequent events or transactions have occurred prior to the completion of fieldwork that could affect the adequacy of the valuation allowance.			
[A][B][D][E]	12. Perform the following analytical procedures and investigate unusual relationships:			
	a. Compare budgeted amounts to actual.			
	b. Compare prior year amounts to current years.			
	c. Compare budgeted deferred amounts to actual.			
	d. Compare prior year deferred to current year.			
B C	13. Update carryforward analyses of the composition of all income tax accounts.			
C	14. Update carryforward analyses of the composition of all deferred tax accounts.			
	B. Section Completion			
	1. The objectives of this audit program have been met.			

This audit program section has been completed in accordance with firm policy.

Done by

Reviewed by

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Obj.		Done By	Date	W/P Ref.

.140 XXI. Notes Payable, Long-Term Debt, and Debt Equivalents

Financial Statement Assertions:

1. Existence or occurrence.
2. Completeness.
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Objectives:

A. Payables exist—To determine that notes payable, long-term debt, and debt equivalents are authorized, properly classified, and described in the financial statements. (Assertions 3 and 5)

B. Period recorded proper—To determine that liabilities are recorded in the proper period at the correct amounts. (Assertions 1, 2 and 4)

C. Expense recognized—To determine that related interest expense (including discount or premium) is accounted for in conformity with generally accepted accounting principles consistently applied. (Assertions 2 and 5)

D. Adequate disclosure—To determine that the financial statements include adequate disclosure of restrictive covenants of loan agreements, pledged assets, etc. (Assertion 5)

NOTE: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Procedures

A. Substantive Test Procedures

Obj.	Procedure	Done By	Date	W/P Ref.
[A] [B] [C] [D]	1. Obtain or prepare an analysis of notes payable, long-term debt, and capitalized lease obligations showing the following:			
	a. Description:			
	(1) Date of origin	____	____	____
	(2) Type of debt and maturity	____	____	____
	(3) Face amount	____	____	____
	(4) Interest rate	____	____	____
	(5) Timing and amount of payments	____	____	____
	b. Principal:			
	(1) Balance at the beginning of the year (period)	____	____	____
	(2) Additions	____	____	____

Obj.		Done By	Date	W/P Ref.
	(3) Payments			
	(4) Balance at the end of the year (period)			
	c. Related Interest:			
	(1) Accrued interest at the beginning of the year (period)			
	(2) Unamortized discount or premium at the beginning of the year (period)			
	(3) Expense incurred during the year (period)			
	(4) Amount paid during the year (period)			
	(5) Accrued at the end of the year (period)			
	(6) Unamortized discount of premium at the end of the year (period)			
[D]	2. Foot and crossfoot analysis, and trace totals to general ledger and subsidiary ledgers for notes payable, long-term debt, and capitalized lease obligations.			
A [D]	3. Trace authorization for all new debt (including such debt equivalents as capitalized leases) to the minutes of the Board of Directors meetings.			
A B C D	4. Examine supporting documentation for all debt (and debt equivalents) and related interest expense (for example, note and loan agreements, bond indentures, lease agreements, correspondence from legal counsel, etc.); obtain copies of debt agreements and highlight restrictive covenants. Note and investigate any apparent violations.			
A B C D	5. Examine lease agreements; identify those which should be capitalized and determine whether they were capitalized at effective rates of interest determined in conformity with generally accepted accounting principles. (Users may wish to insert here references to the current pronouncements on accounting for leases). Obtain information needed for disclosures of lease obligations.			
A D	6. Confirm outstanding balances, terms, conditions, and compliance with covenants with the credit grantor or independent trustee.			
A B	7. Examine cancelled or paid notes and bonds. Consider confirming large notes paid or cancelled during the year (period).			
B C	8. Recompute interest expense and amortization of debt discount or premium.			
[A] C	9. Reconcile interest expense with debt outstanding during the year (period).			
[A] B	10. Review subsequent payment or renewal of substantial notes.			
[A] B	11. Account for all unissued bonds.			
	B. Section Completion			
	1. The objectives of this audit program have been met.			

This audit program section has been completed in accordance with firm policy.

Done by

Reviewed by

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Obj.		Done By	Date	W/P Ref.

.145 XXII. Low Risk Notes Payable, Long-Term Debt, and Debt Equivalents

Financial Statement Assertions:

1. Existence or occurrence.
2. Completeness.
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Objectives:

A. Payables exist—To determine that notes payable, long-term debt, and debt equivalents are authorized, properly classified, and described in the financial statements. (Assertions 1, 3 and 5)

B. Period recorded proper—To determine that liabilities are recorded in the proper period at the correct amounts. (Assertions 1, 2 and 4)

C. Expense recognized—To determine that related interest expense (including discount or premium) is accounted for in conformity with generally accepted accounting principles consistently applied. (Assertions 2 and 5)

D. Adequate disclosure—To determine that the financial statements include adequate disclosure of restrictive covenants of loan aggreements, pledged assets, etc. (Assertion 5)

E. GAAP conformity—To determine that the financial statement presentation and disclosure of notes and long-term debt is in conformity with generally accepted accounting principles consistently applied. (Assertion 5):
NOTE: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Procedures:

A. Substantive Test Procedures

Obj.	Procedure	Done By	Date	W/P Ref.
	1. A determination has been made that there is a low level of combined inherent risk and control risk for all assertions related to notes and long-term debt.	____	____	____
[B]	2. Review the activity in the general ledger for notes and long-term debt transactions for the period being audited and:			
	a. Note and investigate any entries which appear unusual in source or amount.	____	____	____
	b. Compare the opening balance(s) for the period with the final closing balance(s) per the working papers and reports for the preceding period.	____	____	____

Obj.		Done By	Date	W/P Ref.
[A] [B] [C] [D] [E]	3. Obtain or prepare an analysis of notes payable, long-term debt, and capitalized lease obligations showing the following:			
	a. Description:			
	(1) Date of origin.	____	____	____
	(2) Type of debt and maturity.	____	____	____
	(3) Face amount.	____	____	____
	(4) Interest rate (imputed rate).	____	____	____
	(5) Timing and amount of payments.	____	____	____
	(6) Collateral.	____	____	____
	(7) Covenants.	____	____	____
	b. Principal:			
	(1) Balance at the beginning of the year (period).	____	____	____
	(2) Additions.	____	____	____
	(3) Payments.	____	____	____
	(4) Balance at the end of the year (period).	____	____	____
	c. Related Interest:			
	(1) Accrued interest at the beginning of the year (period).	____	____	____
	(2) Unamortized discount or premium at the beginning of the year (period).	____	____	____
	(3) Expense incurred during the year (period).	____	____	____
	(4) Amount paid during the year (period).	____	____	____
	(5) Accrued at the end of the year (period).	____	____	____
	(6) Unamortized discount or premium at the end of the year (period).	____	____	____
[D] [E]	4. Trace totals from schedule prepared in 2 above to general ledger and subsidiary ledgers for notes payable, long-term debt, and capitalized lease obligations.	____	____	____
[A] [B] [C]	5. Perform the following analytical procedures and obtain explanations for unusual results:			
	a. Interest expense to long term debt.	____	____	____
	b. Long term debt to total assets.	____	____	____
	c. Long term debt to stockholders equity.	____	____	____
	d. Times interest earned (net income + interest expense to interest expense).	____	____	____
	e. Cash flow to total debt.	____	____	____
	B. Section Completion			
	1. The objectives of this audit program have been met.	____	____	____

This audit program section has been completed in accordance with firm policy.

______________________ Done by	____	____	____
______________________ Reviewed by	____	____	____

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Obj.		Done By	Date	W/P Ref.

.150 XXIII. Stockholders' Equity

Financial Statement Assertions:

1. Existence or occurrence.
2. Completeness.
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Objectives:

A. Proper authorization and classification—To determine that all transactions and commitments (options, warrants, rights etc.) are properly authorized and classified. (Assertions 1, 2, 3, 4 and 5)

B. Proper recognition and cut-off—To determine that all transactions and commitments are recorded at correct amounts in the proper period. (Assertions 1, 2 and 5)

C. GAAP confirmity—To determine that all transactions and balances are presented in the financial statements in conformity with generally accepted accounting principles consistently applied and accompanied by adequate disclosures. (Assertion 5)

NOTE: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e. [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Procedures:

A. Capital Stock and Additional Paid-In Capital—Substantive Test Procedures

Obj.	Procedure	Done By	Date	W/P Ref.
[C]	1. For each class of stock, identify the number of authorized shares, par or stated value, privileges, and restrictions.	_____	_____	_____
[C]	2. Obtain or prepare an analysis of the activity in the accounts; trace opening balances to the balance sheet as of the close of the year (period) previously audited.	_____	_____	_____
A B	3. Examine minutes, bylaws, and articles of incorporation for provisions relating to capital stock and support for all changes in the accounts including authorization per minutes of Board of Directors and stockholders meetings, and correspondence from legal counsel.	_____	_____	_____
A B	4. Account for all proceeds from stock issues (including stock issued under stock option and stock purchase plans):			
	a. Recompute sales price and applicable proceeds.	_____	_____	_____

Obj.	Procedure	Done By	Date	W/P Ref.
	b. Determine that proceeds have been properly distributed between capital stock and additional paid-in capital.			
A B [C]	5. If company keeps its own stock record books:			
	a. Prepare a carryforward schedule showing certificate number, date and to whom issued, number of shares issued, and date of examination.			
	b. Reconcile schedule to general ledger.			
	c. Determine that all issued certificates have been accounted for as outstanding or cancelled.			
	d. Account for all unissued certificates.			
	e. Examine supporting correspondence for stock transfers.			
A B [C]	6. If the company does not keep its own stock record books:			
	a. Obtain confirmation of shares outstanding from the registrar and transfer agent.			
	b. Reconcile confirmation with general ledger accounts.			
A B [C]	7. For stock options and stock option plans, trace authorization to the minutes of the Board of Directors meetings, review the plan and the option contracts. Obtain or prepare and test analyses of stock options which include the following information:			
	a. For option plans, the date of the plan, number and class of shares reserved for option, method for determining the option price, period during which options may be granted, and identity of persons to whom options may be granted.			
	b. For options granted, identity of persons to whom granted, date of grant, number of shares under option, option price, option period, number of shares as to which options are exercisable, and the market price and value of shares under option as of the date of grant or measurement (first date on which are known both (1) the number of shares individual is entitled to receive, and (2) the option of purchase price, if any).			
	c. For options outstanding, number of shares subject to option at the beginning of the period, activity during the period (additional shares subjected to option, number of shares exercised under options, number of shares associated with options which expired during the period), and number of shares subject to option at the end of the year (period).			
B C	8. Identify all stock rights and warrants outstanding as of the balance sheet date including the number of shares involved, period during which exercisable, and exercise price; determine that the rights and warrants were authorized.			
A B C	9. Identify any stock subscriptions receivable, and:			
	a. Determine if they were authorized.			
	b. Obtain confirmation from subscribers.			
	c. Ascertain that subscriptions receivable are classified as a reduction of stockholders' equity on the balance sheet.			
A B C	10. Obtain or prepare an analysis of the treasury stock account and:			
	a. Inspect the paid checks and other documentation in support of the treasury stock acquisitions.			
	b. Examine the treasury stock certificates; ascertain that the certificates are in the company's name or endorsed to the company.			
	c. Reconcile treasury stock to the general ledger.			
A B C	11. Ascertain amount of dividends in arrears, if any, on cumulative preferred shares.			

Obj.		Done By	Date	W/P Ref.
	B. Retained Earnings—Substantive Test Procedures			
[B]	1. Analyze activity during the period; trace the opening balance to the balance sheet as of the end of the year (period) previously audited; trace net income to financial statement assembly sheets, and trace unrealized loss on noncurrent investments to investment working papers.	____	____	____
A B	2. Determine that dividends paid or declared have been authorized by the Board of Directors and:			
	a. Examine paid checks and supporting documents for dividends paid (selected checks to shareholders or to a dividend disbursing agent).	____	____	____
	b. Recompute amounts of dividends paid and/or payable.	____	____	____
B C	3. Investigate any prior period adjustments and determine if they were made in accordance with FASB Statement No. 16 [AC section A35.101-.103, .106, and .109-.111].	____	____	____
A B C	4. Examine supporting documents and authorization for all other transactions in the account, considering conformity with generally accepted accounting principles.	____	____	____
C	5. Determine amount of restrictions, if any, on retained earnings at end of period which result from loans, other agreements, or state law.	____	____	____
	C. Section Completion			
	1. The objectives of this audit program have been met.	____	____	____

This audit program section has been completed in accordance with firm policy.

________________________ Done by	____	____	____
________________________ Reviewed by	____	____	____

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Obj.		Done By	Date	W/P Ref.

.155 XXIV. Low Risk Stockholders' Equity

Financial Statement Assertions:

1. Existence or occurrence.
2. Completeness.
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Objectives:

A. Proper authorization and classification—To determine that all transactions and commitments (options, warrants, rights, etc.) are properly authorized, classified and valued. (Assertions 1, 2, 3, 4 and 5)

B. Proper recognition and cut-off—To determine that all transactions and commitments are recorded at correct amounts in the proper period. (Assertions 1, 2 and 5)

C. GAAP conformity—To determine that all transactions and balances are presented in the financial statements in conformity with generally accepted accounting principles consistently applied and accompanied by adequate disclosures. (Assertion 5)

NOTE: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Procedures:

A. Substantive Test Procedures

Obj.	Procedure	Done By	Date	W/P Ref.
	1. A determination has been made that there is a low level of combined inherent risk and control risk for all assertions related to equity.	____	____	____
[A] [B]	2. Review activity in the general ledger accounts for stockholder's equity account(s) for the period being audited and:			
	a. Note and investigate any significant entries which appear unusual in amount or source.	____	____	____
	b. Compare the opening balance(s) for the period with the final closing balance(s) per the working papers and reports for the preceding period.	____	____	____

B. Capital Stock and Additional Paid-In Capital—Substantive Test Procedures

Obj.	Procedure	Done By	Date	W/P Ref.
[C]	1. For each class of stock, identify the number of authorized issued and outstanding shares, par or stated value, privileges, and restrictions.	____	____	____
[C]	2. Obtain or prepare an analysis of the activity in the accounts; trace opening balances to the balance sheet as of the close of the year (period) previously audited.	____	____	____
A	3. Examine minutes, bylaws and articles of incorporation for provisions relating to capital stock and support for all changes in the accounts.	____	____	____

Obj.		Done By	Date	W/P Ref.
A B	4. Account for all proceeds from stock issues (recompute sales price and applicable proceeds and determine the proper classification between capital stock and paid in capital).			
A B [C]	5. If company keeps its own stock record books:			
	a. Prepare a carryforward schedule showing certificate number, date and to whom issued, number of shares issued, and date of examination.			
	b. Reconcile schedule to general ledger.			
	c. Determine that all issued certificates have been accounted for as outstanding or cancelled.			
	d. Account for all unissued certificates.			
A B [C]	6. If the company does not keep its own stock record books:			
	a. Obtain confirmation of shares outstanding and reserved from the registrar and transfer agent.			
	b. Reconcile confirmation with general ledger accounts.			
A B [C]	7. For stock options and stock option plans, trace authorization to the minutes of the Board of Directors meetings, review the plan and the option contracts. Obtain or prepare and test analyses of stock options which include the following information:			
	1. For option plans, the date of the plan, number and class of shares reserved for option, method for determining the option price, period during which options may be granted, and identity of persons to whom options may be granted.			
	2. For options granted, identity of persons to whom granted, date of grant, number of shares under option, option price, option period, number of shares as to which options are exercisable, and the estimated market price and value of shares under option as of the date of grant or measurement (first date on which are known both (1) the number of shares individual is entitled to receive, and (2) the option of purchase price, if any) and compensation expense, if applicable.			
	3. For options outstanding, number of shares subject to option at the beginning of the period, activity during the period (additional shares subjected to option, number of shares exercised under options, number of shares associated with options which expired during the period), and number of shares subject to option at the end of the year (period).			
B C	8. Identify all stock rights and warrants outstanding as of the balance sheet date including the number of shares involved, period during which exercisable, and exercise price; determine that the rights and warrants were authorized.			
A B C	9. Identify any stock subscriptions receivable, and:			
	a. Determine if they were authorized.			
	b. Ascertain that subscriptions receivable are classified as a reduction of stockholders' equity on the balance sheet.			
A B C	10. Obtain or prepare an analysis of the treasury stock account and:			
	a. Examine the treasury stock certificates; ascertain that the certificates are in the company's name or endorsed to the company.			
	b. Reconcile treasury stock to the general ledger.			
A B C	11. Ascertain amount of dividends in arrears, if any, on cumulative preferred shares.			

C. Retained Earnings and Other Equity Accounts—Substantive Test Procedures

Obj.		Done By	Date	W/P Ref.
[B]	1. Analyze activity during the period; trace the opening balance to the balance sheet as of the end of the year (period) previously audited; trace net income to financial statement assembly sheets, and trace unrealized loss on noncurrent investments to investment working papers.	____	____	____
	a. Trace the opening balance to the balance sheet as of the end of the year (period) previously audited.	____	____	____
	b. Trace net income to financial statement assembly sheets.	____	____	____
	c. Trace unrealized loss on noncurrent investments to investment working papers.	____	____	____
	d. Dividends paid, etc.	____	____	____
A B	2. Determine that dividends paid or declared have been authorized by the Board of Directors and:			
	a. Examine supporting documents for dividends paid.	____	____	____
	b. Recompute amounts of dividends paid and/or payable.	____	____	____
B C	3. Investigate any prior period adjustments and determine if they were made in accordance with FASB Statement No. 16 [AC section A35.101-.103, .106, and .109-.111].	____	____	____
A B C	4. Examine supporting documents and authorization for all other transactions in the account, considering conformity with generally accepted accounting principles.	____	____	____
C	5. Determine amount of restrictions, if any, on retained earnings at end of period which result from loans, other agreements, or state law.	____	____	____
	D. Section Completion			
	1. The objectives of this audit program have been met.	____	____	____

This audit program section has been completed in accordance with firm policy.

______________________________	____	____	____
Done by			
______________________________	____	____	____
Reviewed by			

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Obj.		Done By	Date	W/P Ref.

.160 XXV. Revenues and Other Income

Financial Statement Assertions:

1. Existence or occurence.
2. Completeness.
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Objectives:

A. Proper recognition—To determine that revenue transactions represent consideration applicable to goods shipped and/or completed services rendered to customers (or clients) in the normal course of business during the year (period). (Assertions 1, 3, 4 and 5)

B. Revenue realized—To determine that revenue transactions have resulted in collections or bona fide receivables. (Assertions 1 and 2)

C. Revenue recorded—To determine that all revenues earned during the year (period) are recorded and included in the financial statements. (Assertions 1, 2 and 5)

D. Proper classification—To determine that revenues are properly classified and described in the financial statements and accompanied by adequate disclosure. (Assertions 4 and 5)

E. Proper classification of other income—To determine that other income has been properly recognized, classified and described in the statement of income. (Assertions 2 and 5)

F. GAAP conformity—To determine that the income statement is prepared in conformity with generally accepted accounting principles consistently applied. (Assertion 5)

NOTE: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Procedures:

A. Substantive Test Procedures

1. Obtain the sales journal and for a selected period(s):
   a. Trace totals from the sales journal to the general ledger control accounts for revenues, receivables, and such other accounts as salesmen's commissions, provisions, and allowances for product warranties, etc. ____ ____ ____

Obj.		Done By	Date	W/P Ref.
	b. Trace selected individual items from the sales journal to such other subsidiary records as the salesmen's commissions detail, and entries to charge cost.			
	c. Reconcile the sales journal to the entries to charge cost of sales and credit inventory.			
	d. Test the arithmetic accuracy of the footings and crossfootings of the journals.			
	2. Obtain the cash receipts journal and perform the following on a test basis for a selected period(s):			
	a. Trace totals to the general ledger for both the cash account and applicable account distributions such as accounts receivable, cash sales, investment income, and additions to notes payable (re: proceeds).			
	b. Test the arithmetic accuracy of the footings and crossfootings of the cash receipts journal; reconcile total receipts to total deposits per the bank statement.			
A B C D [F]	3. Obtain or prepare comparative analysis of sales for the current and preceding year (period) (and budgeted amounts) including gross sales, discounts granted, returns, credits allowed, and net sales. (Consider additional subclassifications such as sales by product line, division, seasons during the year or period, etc.). (Note: Revenue and profit recognition on long-term contracts are specialized matters which are common to certain industries; see the applicable industry audit guides.)			
	a. Agree balances to general ledger and prior years' workpapers.			
	b. Obtain explanations for significant or unusual fluctuations from the preceding year (period) and from budgeted amounts (SAS No. 56 [AU section 329]).			
A F	4. Ascertain whether the entity ships goods to be held on consignment by others, and if so:			
	a. Identify the control accounts, procedures, and entities to whom consignment shipments are made.			
	b. Examine consignment agreements.			
	c. Review subsidiary accounts for entities to whom consignment shipments are made; examine supporting detail and ascertain that shipments on consignment are properly recorded.			
	d. Review shipping advices and trace consignment shipments to the applicable subsidiary records and control accounts; ascertain that consignment shipments are correctly classified and recorded.			
	e. Investigate old or significant consignments to determine whether there are any unrecorded sales.			
[A] F	5. Identify amounts of sales to affiliates, obtain an understanding of their business purpose, and note for disclosure and/or tracing to consolidation eliminating entries. Identify amounts of sales to other related parties (see SAS No. 45 [AU section 334]).			
A B C	6. For sales cut off as of the closing date for the year (period) and/or the date of the physical inventory:			
	a. Select sales invoices for testing from the sales register for several days before and after the year end (or at the physical inventory date) and examine shipping records and determine that they were recorded in the proper period.			
	b. Select credit memos issued after year end and examine underlying documentation (for example, record of receipt of returned goods) to determine period to which credit memo is applicable and whether it was recorded in the proper period.			

Obj.		Done By	Date	W/P Ref.
	c. Inquire of the client if there are any unprocessed sales or customer credit memos. Inspect supporting documents to determine whether they should have been recorded prior to year end.	____	____	____
A C E	7. Ascertain that the following income accounts have been traced to the analysis working papers for examination of the related balance sheet accounts:			
	a. Interest income (notes receivable, debt securities, capitalized leases, etc.)	____	____	____
	b. Dividend income and realized gain (marketable equity securities)	____	____	____
	c. Increase in investments accounted for on the equity method (investments)	____	____	____
	d. Gain on sale of property and equipment (property and equipment)	____	____	____
A E	8. Obtain (or prepare) an analysis of rent and royalty income and examine supporting agreements (should be related to examination of leases and other agreements).	____	____	____
	B. Section Completion			
	1. The objectives of this audit program have been met.	____	____	____

This audit program section has been completed in accordance with firm policy.

______________________________ ____ ____ ____
Done by

______________________________ ____ ____ ____
Reviewed by

[The next page is 5487-3.]

The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

Obj.		Done By	Date	W/P Ref.

.165 XXVI. Low Risk Revenues and Other Income

Financial Statement Assertions:

1. Existence or occurrence.
2. Completeness.
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Objectives:

A. Proper recognition—To determine that revenue transactions represent consideration applicable to goods shipped and/or completed services rendered to customers (or clients) in the normal course of business during the year (period). (Assertions 1, 3, 4 and 5)

B. Revenue realized—To determine that revenue transactions have resulted in collections or bona fide receivables. (Assertions 1 and 2)

C. Revenue recorded—To determine that all revenues earned during the year (period) are recorded and included in the financial statements. (Assertions 1, 2 and 5)

D. Proper classification—To determine that revenues are properly classified and described in the financial statements and accompanied by adequate disclosure. (Assertions 4 and 5)

E. Proper classification of other income—To determine that other income has been properly recognized, classified, and described in the statement of income. (Assertions 2 and 5)

F. GAAP conformity—To determine that the income statement is prepared in conformity with generally accepted accounting principles consistently applied. (Assertion 5)

NOTE: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e. [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Procedures:

A. Substantive Test Procedures

Obj.	Procedure	Done By	Date	W/P Ref.
	1. A determination has been made that there is a low level of combined inherent risk and control risk for all assertions related to revenue.	____	____	____
[A] [B] [C]	2. Review the activity in the general ledger for sales, return and allowances, cash receipts, sales commissions, etc., for the period being audited, note and investigate any entries which appear unusual in source or amount.	____	____	____

Obj.		Done By	Date	W/P Ref.
[A] [B] [C]	3. Obtain the cash receipts journal and perform the following on a test basis for a selected period(s):			
	a. Trace totals to the general ledger for both the cash account and applicable account distributions such as accounts receivable, cash sales, investment income, and additions to notes payable (re: proceeds).	____	____	____
	b. Test the arithmetic accuracy of the footings and crossfootings of the cash receipts journal; reconcile total receipts to total deposits per the bank statement.	____	____	____

Obj.		Done By	Date	W/P Ref.
A B C D [F]	4. Obtain or prepare comparative analysis of sales for the current and preceding year (period) (and budgeted amounts) including gross sales, discounts granted, returns, credits allowed, and net sales. (Consider additional subclassifications such as sales by product line, division, seasons during the year or period, etc.). (Note: Revenue and profit recognition for certain industries are specialized matters which are common to those industries; see the applicable industry audit guides.)	____	____	____
	a. Agree balances to general ledger.	____	____	____
	b. Obtain explanations for significant or unusual fluctuations from the preceding year (period) and from budgeted amounts (SAS No. 56 [AU section 329]).	____	____	____
	c. Compare analysis with industry averages, if available.	____	____	____
	d. Calculate the following ratios and investigate unusual results:			
	(1) Accounts receivable turnover.	____	____	____
	(2) Sales return and allowances to sales.	____	____	____
	(3) Days sales in accounts receivable.	____	____	____
	(4) Cost of goods sold to sales.	____	____	____
[A] F	5. Identify amounts of sales to affiliates, obtain an understanding of their business purpose, and note for disclosure and/or tracing to consolidation eliminating entries. Identify amounts of sales to other related parties (see SAS No. 45 [AU section 334]).	____	____	____
A C E	6. Ascertain that the following income accounts have been traced to the analysis working papers for examination of the related balance sheet accounts:			
	a. Interest income (notes receivable, debt securities, capitalized leases, etc.).	____	____	____
	b. Dividend income and realized gain (marketable equity securities).	____	____	____
	c. Increase in investments accounted for on the equity method (investments).	____	____	____
	d. Gain on sale of property and equipment (property and equipment).	____	____	____
A E	7. Obtain (or prepare) an analysis of rent and royalty income and examine supporting agreements (should be related to examination of leases and other agreements).	____	____	____
	B. Section Completion			
	1. The objectives of this audit program have been met.	____	____	____

This audit program section has been completed in accordance with firm policy.

Done by	____	____	____
Reviewed by	____	____	____

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Obj.		Done By	Date	W/P Ref.

.170 XXVII. Operating and Other Expenses

Financial Statement Assertions:

1. Existence or occurrence.
2. Completeness.
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Objectives:

A. Properly recorded—To determine that reported expenses include costs which are properly allocable to the year (period) and are properly matched with revenues. (Assertions 1, 2 and 4)

B. Proper recognition—To determine that recognition has been given to all costs and expenses (including losses) which should be recognized. (Assertions 1, 2, 3 and 4)

C. Taxes properly recorded—To determine that all tax temporary differences have been accounted for. (Assertions 2 and 5)

D. Proper classification—To determine that extraordinary items have been properly classified and disclosed. (Assertions 1 and 5)

E. GAAP conformity—To determine that the income statement is prepared in conformity with generally accepted accounting principles consistently applied. (Assertion 5)

F. Proper classification—To determine that costs and expenses are appropriately classified and described in the statement of income. (Assertion 5)

NOTE: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Procedures:

A. Substantive Test Procedures

1. Obtain the cash disbursements journal and for a selected period(s):
   a. Trace totals from the cash disbursements journal to the general ledger control account for accounts payable, cash, and such other accounts as payroll expense, rent expense, insurance expense, interest expense, etc. _____ _____ _____

Obj.		Done By	Date	W/P Ref.
	b. Trace selected individual items from the cash disbursements journal to such other subsidiary records as the payroll journal, and other entries to charge the expense.			
	c. Test the arithmetic accuracy of the footings and crossfooting of the journals.			
A B D E F	2. Obtain or prepare comparative analyses showing amounts for the current and preceding years or periods (and budgeted amounts) and the amounts of changes for the following (SAS No. 56 [AU section 329]):			
	a. Agree amounts to the general ledger and the prior period workpapers.			
	b. Obtain explanations for significant or unusual fluctuations in expense account balances from the preceding year (or period) and from budgeted amounts. (Consider results of work done on accrued expense balances for the current and preceding year.) (SAS No. 56 [AU section 329]).			
	c. Consider whether the classification of expenses is in conformity with generally accepted accounting principles consistently applied.			
	d. Obtain explanations for significant or unusual differences between the current year and preceding year relationships of statement classifications of expenses as percentages of revenue (SAS No. 56 [AU section 329]).			
	e. Compare the inventory turnover and gross profit ratios for the current and preceding year (SAS No. 56 [AU section 329]).			
A B C F	3. Determine that the following expense accounts have been traced to the analysis working papers for examination of the related asset and liability balances:			
	a. Bad debt expense (allowance for doubtful accounts—trade receivables)			
	b. Insurance expense (prepaid insurance and accrued premiums for workmen's compensation)			
	c. Property taxes (prepaid and/or accrued property taxes)			
	d. Depreciation expense (property and equipment and accumulated depreciation)			
	e. Amortization costs (intangible assets)			
	f. Interest expense (notes payable, long-term debt, capitalized leases)			
	g. Provision for income taxes (liability for income taxes currently payable, deferred income taxes)			
	h. Realized losses on current investments (marketable equity securities)			
	i. Loss on sale or disposition of property and equipment (property and equipment)			
A B D E F	4. Obtain or prepare analyses of the following accounts and examine supporting detail (on a completed or test basis as deemed appropriate):			
	a. Professional fees (lawyers' invoices should have been examined and noted during work on commitments and contingencies concerning pending litigation).			
	b. Rent and royalty expense (should be related to examination of leases and other agreements—other lease obligations or license agreements may be disclosed).			
	c. Officers' salaries and directors' fees (to determine that amounts agree with those authorized per the minutes of Board of Directors' meetings).			

Obj.		Done By	Date	W/P Ref.
	d. Maintenance and repairs (if not already tested in connection with property and equipment; determine that expenses do not include amounts which should be capitalized).	____	____	____
	e. Travel and entertainment (review client's procedures for compliance with income tax requirements).	____	____	____
	f. Unusual classifications such as loss provisions for discontinued operations and plant closings.	____	____	____
A B	5. Consider obtaining or preparing analyses and examining supporting detail on a test basis for the following expenses:			
	a. Research and development	____	____	____
	b. Advertising	____	____	____
	c. Contributions	____	____	____
[C]	6. Based on the assessment of control risk of assertions related to payroll, consider reconciling wages and salaries and payroll taxes to amounts reported per the payroll tax returns.	____	____	____
	B. Section Completion			
	1. The objectives of this audit program have been met.	____	____	____

This audit program section has been completed in accordance with firm policy.

______________________ Done by	____	____	____
______________________ Reviewed by	____	____	____

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Obj.		Done By	Date	W/P Ref.

.175 XXVIII. Low Risk Operating and Other Expenses

Financial Statement Assertions:

1. Existence or occurrence.
2. Completeness.
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Objectives:

A. Properly recorded—To determine that reported expenses include costs which are properly allocable to the year (period) and are properly matched with revenues. (Assertions 1, 2 and 4)

B. Proper recognition—To determine that recognition has been given to all costs and expenses (including losses) which should be recognized. (Assertions 1, 2, 3 and 4)

C. Proper classification—To determine that costs and expenses are appropriately classified and described in the statement of income. (Assertion 5)

D. GAAP conformity—To determine that the financial statement presentation and disclosure of expenses is in conformity with generally accepted accounting principles consistently applied. (Assertion 5)

NOTE: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e. [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Procedures:

A. Substantive Test Procedures

Obj.	Procedure	Done By	Date	W/P Ref.
	1. A determination has been made that there is a low level of combined inherent risk and control risk for all assertions related to expenses.	____	____	____
[A] [B] [C] [D]	2. Review the activity in the general ledger for the expense accounts for the period being audited, note and investigate any entries which appear unusual in source and amount.	____	____	____
A B C D	3. Obtain or prepare comparative analyses showing amounts for the current and preceding years or periods (and budgeted amounts) and the amounts of changes for the following (SAS No. 56 [AU section 329]):			
	a. Agree amounts to the general ledger and the prior period workpapers.	____	____	____

Obj.		Done By	Date	W/P Ref.
	b. Obtain explanations for significant or unusual fluctuations in expense account balances from the preceding year (or period) and from budgeted amounts. (Consider results of work done on accrued expense balances for the current and preceding year.) (SAS No. 56 [AU section 329])			
	c. Compare analysis with industry averages.			
	d. Calculate the following ratios and investigate unusual results:			
	(1) Interest expense to average debt.			
	(2) Interest expense to net sales.			
	(3) Repairs and maintenance to property, plant, and equipment.			
	(4) Insurance coverage to inventory and property, plant, and equipment.			
	(5) Payroll taxes to payroll expense.			
	(6) Employee benefits to payroll expense.			
	(7) Operating expenses as a percentage of net sales.			
	(8) Amortization/depreciation expense to net sales.			
	(9) Officer's compensation to net sales.			
	B. Section Completion			
	1. The objectives of this audit program have been met.			

This audit program section has been completed in accordance with firm policy.

Done by

Reviewed by

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Obj.		Done By	Date	W/P Ref.

.180 XXIX. Litigation, Claims, and Assessments

Financial Statement Assertions:

1. Existence or occurrence.
2. Completeness.
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Objectives:

A. Contingencies exist—Identify the existence of any contingencies arising from litigation, claims, and assessments; when the underlying cause occurred; the likelihood of an unfavorable outcome, and the amount or range of possible loss. (Assertions 1, 2, 3 and 4)

B. Proper recording and disclosure—The financial statements include proper accruals and/or disclosure of the contingencies. (Assertion 5)

NOTE: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Procedures:

A. Substantive Test Procedures

Obj.	Procedure	Done By	Date	W/P Ref.
A B	1. Assemble findings concerning litigation, claims, and assessments from such other procedures as:			
	a. Reading minutes of meetings of stockholders, directors, and appropriate committees held during and subsequent to the period being audited.	____	____	____
	b. Reading contracts, loan agreements, leases, and correspondence from taxing or other governmental agencies and similar documents.	____	____	____
	c. Obtaining information concerning guarantees from bank confimation forms.	____	____	____
	d. Inspecting other documents for possible guarantees by the client.	____	____	____
A B	2. Inquire of and discuss with management the policies and procedures adopted for identifying, evaluating, and accounting for litigation, claims, and assessments.	____	____	____
A B	3. Obtain from management a description and evaluation of litigation, claims, and assessments that existed at the date of the balance sheet being reported on, and during the period from the balance sheet date to the date the information is furnished, including:			
	a. Identification of those matters referred to legal counsel.	____	____	____

Obj.		Done By	Date	W/P Ref.
	b. Assurances from management, ordinarily in writing, that they have disclosed all such matters required to be disclosed by FASB Statement No. 5 [AC section C59].			
A B	4. Examine documents in the client's possession concerning litigation, claims, and assessments, including correspondence and invoices from lawyers.			
A B	5. Obtain assurance from management, ordinarily in writing, that they have disclosed all unasserted claims that their lawyer has advised them are probable of assertion and must be disclosed in accordance with FASB Statement No. 5 [AC section C59]. Also the auditor, with the client's permission, should inform their lawyer that the client has given the auditor this assurance. This client representation may be communicated by the client in the inquiry letter or by the auditor in a separate letter.			
A B	6. Request the client's management to send a letter of inquiry to those lawyers consulted by the client concerning, litigation, claims, and assessments (SAS No. 12 [AU section 337] for guidance).			
	B. Section Completion			
	1. The objectives of this audit program have been met.			

This audit program section has been completed in accordance with firm policy.

Done by

Reviewed by

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Obj.		Done By	Date	W/P Ref.

.190 XXX. Subsequent Events

Financial Statement Assertions:

1. Existence or occurrence.
2. Completeness.
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Objectives:

A. Existence of subsequent event—Any events or transactions occuring after the balance sheet date, but before issuance of the financial statements and auditor's report (subsequent events) which require adjustment or disclosure in the financial statements. (Assertions 1, 2, 3 and 4)

B. Proper recognition—The financial statements have been adjusted for changes in estimates resulting from evidence provided by subsequent events. (Assertions 1, 2, 3 and 4)

C. Proper disclosure—The financial statements include adequate disclosure of evidence provided by subsequent events which should not result in adjustment of the financial statements but should be disclosed. (Assertion 5)

NOTE: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Procedures:

A. Substantive Test Procedures

Obj.	Procedure	Done By	Date	W/P Ref.
A B C	1. Read the latest available interim financial statements:			
	a. Compare them with the financial statements being reported upon and make any other comparisons considered appropriate in the circumstances.	____	____	____
	b. Inquire of officers and other executives having responsibility for financial and accounting matters as to whether the interim statements have been prepared on the same basis as that used for the statements under audit.	____	____	____
A B C	2. Inquire of and discuss with officers and other executives having responsibility for financial and accounting matters as to:			
	a. Whether any substantial contingent liabilities or commitments existed at the date of the balance sheet being reported on or at the date of inquiry.	____	____	____

Obj.		Done By	Date	W/P Ref.
	b. Whether there was any significant change in the capital stock, long-term debt, or working capital to the date of inquiry.	____	____	____
	c. Whether there were any significant changes in estimates with respect to amounts included or disclosed in the financial statements being reported on.	____	____	____
	d. Whether any unusual adjustments had been made during the period from the balance sheet date to the date of inquiry.	____	____	____
A	3. Read the available minutes of meetings of stockholders, directors, and appropriate committees; as to meetings for which minutes are not available, inquire about matters dealt with at such meetings.	____	____	____
A	4. Assemble pertinent findings resulting from response of client's legal counsel and other auditing procedures concerning litigation, claims, and assessments.	____	____	____
A B C	5. Obtain a letter of representation, dated as of the date of the auditor's report, from appropriate officials, generally the chief executive officer and chief financial officer in accordance with SAS No. 19 (AU section 333).	____	____	____
A B C	6. Make such additional inquiries or perform such procedures deemed necessary and appropriate to dispose of questions that arise in carrying out the foregoing procedures, inquiries, and discussions.	____	____	____
	B. Section Completion			
	1. The objectives of this audit program have been met.	____	____	____

This audit program section has been completed in accordance with firm policy.

Done by	____	____	____
Reviewed by	____	____	____

[The next page is 5551.]

AAM Section 5410

Suggested Supplemental Reference Materials for Use With Illustrative Audit Program for Corporations

.01 Suggested Supplemental Reference Materials

Accounting Standards—Current Text (Financial Accounting Standards Board)

Professional Standards (American Institute of CPAs)

Index to Accounting and Auditing Technical Pronouncements (American Institute of CPAs)

AICPA Audit and Accounting Guides—when applicable

Integrated Practice Series engagement manuals (American Institute of CPAs)

Financial Statement Preparation Manual (American Institute of CPAs)

Technical Practice Aids (American Institute of CPAs)

Accounting Trends & Techniques (American Institute of CPAs)

Accountants' Handbook by Carmichael, Lilien & Mellman (Wiley)

Montgomery's Auditing by O'Reilly, Hirsch, Defliese and Jaenicke (Wiley)

Handbook of Modern Accounting by Davidson & Weil (McGraw-Hill)

Kohler's Dictionary for Accountants by Cooper & Ijiri (Prentice-Hall)

EITF Abstracts—A Summary of Proceedings of the FASB Emerging Issues Task Force (Financial Accounting Standards Board)

Financial Reports Surveys series (American Institute of CPAs)

Audit and Accounting Manual (American Institute of CPAs)

Accounting Standards—Original Pronouncements (Financial Accounting Standards Board)

Technical Information for Practitioners Series (TIPS) (American Institute of CPAs)

Disclosure Checklist series (American Institute of CPAs)

Accountants' Index (American Institute of CPAs)

Federal Audit Guides (Commerce Clearing House)

[The next page is 5601.]

AAM Section 5600

Illustrative Audit Program for State and Local Governmental Units

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	Done By	Date	W/P Ref.
.010 I. Engagement Planning and Administration			
A. Engagement Planning Procedures			
1. Determine that a signed engagement letter proposal or contract covering the current engagement is on file. Read letter for any special provisions.	____	____	____
2. Determine that decision to accept engagement (in case of new client) or to retain client has been documented. (See AAM section 11,200.09.)	____	____	____
3. Review those suggested reference materials shown in AAM section 5610 which are relevant to the scope of the engagement.	____	____	____
4. If this is a new client, ascertain that required communications in SAS No. 7 *Communications Between Predecessor and Successor Auditors* [AU section 315], if any, have been made.	____	____	____
5. Ascertain that all applicable independence rules, particularly those related to performance of accounting services, have been met.	____	____	____
6. Obtain an initial, overall understanding of the client's operations:			
a. Determine type of local government (home rule status, etc.).	____	____	____
b. Inquire of management and assess management's identification of local laws which pertain to the basic plan or organization and related responsibilities of executive, legislative, and administrative personnel.	____	____	____
c. Inquire if the local government is required to have a single audit. Contact the entity's oversight or cognizant audit agency to determine if the agency has any concerns or special instructions which need to be taken into consideration in planning and conducting the audit.	____	____	____
d. Determine that audit will satisfy relevant legal, regulatory, or contractual requirements.	____	____	____
e. If audit does not satisfy "d," above, communicate this to the management and the audit committee (or others with equivalent authority, such as Board of Directors, Board of Trustees) either in writing or orally. If orally, document in workpapers.	____	____	____
f. List local government officials and members of governing body by name and title.	____	____	____
g. Determine types of reports that need to be issued.	____	____	____

	Done By	Date	W/P Ref.
h. Determine which governmental units are to be included in the financial statements as a possible component unit of the reporting entity.	_____	_____	_____
i. Determine the extent of involvement of other audit firms and inquire about their independence and professional reputation. Clearly define the responsibilities of each audit firm and which firm is the primary auditor.	_____	_____	_____
j. Review prior year's reports and financial statements.	_____	_____	_____
k. Review prior year's working papers and permanent file, particularly the following:			
(1) Internal control questionnaires, memoranda, and related summary evaluation notes.	_____	_____	_____
(2) Engagement time summary records.	_____	_____	_____
(3) Adjusting and reclassification entries.	_____	_____	_____
(4) Audit partner memoranda regarding consultations on accounting and auditing matters.	_____	_____	_____
(5) Suggestions for next audit.	_____	_____	_____
l. Review most recent management letter.	_____	_____	_____
m. Discuss engagement with firm personnel previously assigned and/or responsible for nonaudit services.	_____	_____	_____
n. Review any interim financial statements or reports for current year to determine whether amounts and relationships appear reasonable in comparison to prior year.	_____	_____	_____
o. Review client's correspondence file.	_____	_____	_____
p. Obtain copies of meetings of the governing body and relevant committees.	_____	_____	_____
q. Obtain copy (including all amendments) of client's current budget. (For all funds legally budgeted.)	_____	_____	_____
r. Obtain current property tax calendar.	_____	_____	_____
s. Obtain a list of all related parties.	_____	_____	_____
t. Make appropriate notations regarding matters to be discussed with audit partner, manager and/or in-charge auditor.	_____	_____	_____
7. Discuss the following (and other appropriate) matters with appropriate client personnel (including the audit committee of the governing body, if applicable):			
a. Changes in operations, including pending/planned changes.	_____	_____	_____
b. Changes in accounting methods or accounting principles applied.	_____	_____	_____
c. Changes in key personnel (accounting and data processing).	_____	_____	_____
d. Significant accounting or reporting problems.	_____	_____	_____
e. Principal findings of internal auditor, if applicable.	_____	_____	_____
f. Changes in data processing methods or equipment.	_____	_____	_____
g. Significant legal matters and contingencies.	_____	_____	_____
h. Disposition of prior year's management letter points.	_____	_____	_____
i. Disposition of prior year's reportable conditions.	_____	_____	_____
j. Extent of client assistance to be provided.	_____	_____	_____
k. Timing of preliminary audit work, inventory observation, confirmation procedures, final audit work, etc.	_____	_____	_____
l. Due dates for delivery of report(s).	_____	_____	_____
m. Closing information to be prepared (check applicable items):	_____	_____	_____
(1) Closing Journal Entries.	_____	_____	_____
(2) Post Closing Trial Balance.	_____	_____	_____
(3) Audit Adjusting Entries.	_____	_____	_____
(4) Reversing Journal Entries.	_____	_____	_____

	Done By	Date	W/P Ref.
n. Other matters (prepare list and attach to program).			
o. Make appropriate notations regarding matters to be discussed with audit partner, manager and/or in-charge auditor.			
8. Identify material accounting estimates which should be made and recorded by the client.			
9. If client has internal audit staff, read reports and related correspondence, and consider possible effect of internal audit work and findings on scope of the audit.			
10. Contact oversight or cognizant agency when applicable, to obtain its perspective on key compliance issues.			
11. Obtain an understanding of the effect of laws, regulations, and ordinances having a direct and material effect on the financial statements:			
a. Obtain from management a list of such laws and regulations.			
b. Assess the accuracy and completeness of the list provided by management by considering knowledge obtained from prior audits, discussions with the entity's chief financial officer, legal counsel or grant administrator, the review of agreements, the review of minutes, inquiries of audit oversight organizations and grantors, and the review of available information obtained from (state) societies of CPAs or associations of governments. Document the assessment for inclusion in the working papers.			
12. Obtain an understanding of the client's internal control structure, including those aspects relating to compliance with the laws and regulations identified above, to assist in the planning of the determination of the nature, timing, and extent of tests to be performed:			
a. Complete questionnaires and prepare flowcharts and/or narrative descriptions relating to the client's policies, procedures, and records relevant to audit planning. Consideration should be given to all three elements of the internal control structure to obtain sufficient knowledge of the design of relevant policies, procedures, and records and to determine whether those policies, procedures, and records have been placed in operation.			
b. Assess control risk for financial statement assertions, including those relating to compliance with laws and regulations that have a direct and material effect on the financial statements.			
(1) For each assertion for which control risk is assessed at the maximum, record that conclusion in the working papers.			
(2) For each assertion for which a lowering of control risk below the maximum is deemed feasible and efficient:			
(a) Identify the key policies and procedures which will be subjected to audit tests.			
(b) Conduct audit tests to determine how the policies or procedures were applied, the consistency with which they were applied, and by whom they were applied. Working papers relating to the tests should describe the policy or procedure tested, test objectives, sample selection, test criteria, test results, and conclusions concerning the effectiveness of policies or procedures.			
(c) Document conclusions in the working papers concerning the assessed level of control risk for the assertion.			
13. Perform appropriate analytical procedures and determine effect on the nature, timing, and extent of other audit procedures. For selected account balances and classes of transactions compare recorded amounts to:			
a. Prior year amounts, adjusted for known changes from the prior year to the current year;			
b. Current year amounts to budgeted amounts and/or forecasts;			
c. Other financial/nonfinancial information for which plausible relationships exist; and			

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d. Prepare notes concerning unusual or unexpected transactions, events, amounts, ratios or trends that might have planning ramifications. Also, explain the dispositions made of such matters.

14. Use the understanding obtained of the internal control structure and consider factors influencing audit risk to evaluate the risk of material misstatements arising from errors, irregularities, and/or illegal acts, including the risk of management misrepresentations. Document conclusions in the working papers and their effects on engagement staffing, extent of supervision, and overall strategy for the conduct and scope of audit.

15. Use the information obtained or developed concerning materiality levels, the internal control structure and the related assessments of control risk, the results of analytical procedures, and the evaluation of other factors impacting on audit risk to plan:

 a. The nature, timing, and extent of substantive tests;
 b. Staffing requirements and related levels of supervision;
 c. The overall strategy for the conduct and scope of audit; and
 d. Revisions to the audit program.

16. Estimate time required to complete audit procedures and prepare appropriate planning documents (engagement time summary, scheduling and staffing summary, etc.).

17. Hold a planning conference among the audit partner, manager, and/or in-charge auditor (and firm specialists, if deemed necessary), and:

 a. Discuss information obtained and results of procedures performed to date based on completion of previous steps.
 b. Discuss any special audit risks or client conditions (see AAM section 5600.160) deemed to exist.
 c. Ascertain that recent accounting/auditing pronouncements affecting the client have been considered.
 d. Develop plans to solve known or anticipated accounting/auditing problems.
 e. Determine tentative minimum amount for judging materiality of possible past adjustments.
 f. Discuss types/general formats of reports to be rendered and planned delivery dates.
 g. Discuss possible rotation of certain auditing procedures as well as areas of audit emphasis.
 h. Discuss methods to maximize the amount of interim work to be done.
 i. Obtain and record audit partner's approval for:
  (1) Technique(s) used to document the internal control structure.
  (2) Approach used to audit computer generated records.
  (3) Use of statistical sampling methods.
  (4) Assessment of audit risk and materiality.
  (5) Audit programs.
  (6) Time budget and staffing of engagement.
  (7) Prepare a memorandum summarizing the results of the planning conference, particularly all decisions reached.

18. Prepare listing of schedules/analyses to be prepared by client (and working paper set-ups, if considered necessary) and deliver to client.

B. Engagement Administration and Supervision Procedures

	Done By	Date	W/P Ref.
1. Communicate results of planning conference with client and firm personnel to staff persons assigned to the engagement, particularly matters relating to portions of engagement assigned to them.			
2. Schedule timing of work to be done on priority basis, assigning top priorities to more significant or problem areas of engagement.			
3. Obtain all documents and information required for the permanent file and remove superseded materials for filing in a closed file.			
4. Accumulate all points to be included in the report on the internal control structure or in a management letter (or to be communicated verbally to the client).			
5. Ascertain that all steps in all audit programs have been considered and/or completed, and that any modifications to the programs resulting from changed conditions have been properly approved and documented.			
6. Review financial statements and notes and determine:			
a. The adequacy of evidence gathered in response to unusual or unexpected balances identified during audit planning or audit performance;			
b. The existence of unusual or unexpected balances or relationships which have not been evaluated; and			
c. Whether additional evidential matter is necessary to explain unexpected differences between reported amounts and expected amounts or relationships.			
7. Ascertain that working papers include appropriate memoranda regarding consultations with firm specialists, outside consultations and resolution of differences of opinion, if any, among firm personnel regarding accounting auditing matters.			
8. Determining that differences between the accounting records and the evidential matter gathered during the application of audit procedures have been evaluated as to both their quantitative and qualitative effects.			
9. In the event that illegal acts were noted, determine that:			
a. An understanding of the nature of the acts was obtained;			
b. The circumstances in which it occurred were evaluated;			
c. The effect of the illegal act on the financial statements was considered; and			
d. Such other auditing procedures as indicated necessary in the circumstances were performed.			
10. Determine that required communications, proper as to form and content, have been made as necessary to disclose irregularities and/or illegal acts noted during the course of the audit.			
11. Determine whether the audit work performed indicates that a substantial doubt exists with regard to the local government's ability to continue as a going concern for a reasonable period of time. If a substantial doubt exists:			
a. Obtain information about management's plans, assess the expected effectiveness of the plans, and gather evidence to evaluate pertinent provisions of those plans and to support audit conclusions concerning the local government's ability or inability to continue as a going concern;			
b. Evaluate the adequacy of the related financial statement disclosures; and			
c. Consider the effects on the audit report.			
12. Determine that the following matters have been communicated to those who have responsibility for oversight of the financial reporting process (for example, the audit committee or others with equivalent authority and responsibility) and include documentation to that effect in the working papers:			
a. Management's responsibility for the internal control structure and the financial statements;			
b. Audit conducted in accordance with GAAS or GAGAS provides reasonable, rather than absolute, assurance;			

	Done By	Date	W/P Ref.
c. Significant accounting policy implementation or change;			
d. Significant unusual transactions and the methods used to account for them;			
e. Significant accounting policies relating to controversial or emerging areas for which there is no authoritative guidance or consensus;			
f. Processes used by management to develop sensitive accounting estimates and the basis for audit conclusions concerning the reasonableness of those estimates;			
g. Significant audit adjustments;			
h. The auditor's responsibility for other information in documents containing audited financial statements;			
i. Disagreements with management;			
j. Consultations by management with other accountants;			
k. Major issues discussed with management prior to retention;			
l. Difficulties encountered in performing the audit;			
m. Irregularities and/or illegal acts;			
n. Significant deficiencies in the design or operation of the internal control structure ("reportable conditions"); and,			
o. Other matters relevant to oversight responsibilities.			
13. Ascertain that all working papers have been headed, indexed, cross-referenced, initialed, and dated. If they were initially prepared by client, they should be marked "Prepared by Client" or "PBC."			
14. Accumulate all pending items in one listing, and dispose of all other follow-up or "TO DO" sheets and any other similar notations in the files.			
15. Ascertain that all time has been posted to the daily time control records, and record totals on the engagement time summary. Write explanations for any significant variations between budgeted and actual time.			

This audit program section has been completed in accordance with firm policy.

	Date
Done by	
Reviewed by	

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Obj.		Done By	Date	W/P Ref.

.020 II. Cash

Financial Statement Assertions

1. Existence or occurrence
2. Completeness
3. Rights and obligations
4. Valuation or allocation
5. Presentation and disclosure

Audit Objectives

A. Cash balances as stated in the balance sheet properly represent cash and cash items on hand, in banks, or in transit. (Assertions 1, 2, 3, 4, and 5)

B. Cash is properly classified in the financial statements and adequate disclosure (by segregation or otherwise) is made of restricted or committed funds or of cash not subject to immediate withdrawal and accounts with credit balances. (Assertions 3, 4, and 5)

C. Deposits are properly classified as to credit risk as required by GASB Statement No. 3. (Assertions 4 and 5)

D. Applicable accounting principles have been consistently applied. (Assertions 4 and 5)

Note: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

A. Evaluation of Internal Control Structure

1. Review the documentation and conclusions resulting from the steps taken to understand and test the internal control structure policies, procedures, and records relevant to planning the audit of cash. _____ _____ _____
2. Consider the understanding obtained of the internal control structure, the assessed level of control risk (together with assessment of inherent risk), and the acceptable level of detection risk to determine the nature, timing, and extent of substantive tests. _____ _____ _____
3. Revise the audit program, as appropriate, following the consideration of the internal control structure and related audit risks. _____ _____ _____

B. Analytical Procedures

1. Review the planning procedures applicable to analytical procedures performed on cash and consider the result of the procedures in determining the nature, timing, and extent of other audit procedures. _____ _____ _____

Obj.	Procedure	Done By	Date	W/P Ref.
	2. Revise the audit program, as appropriate, following consideration of the results of the analytical procedures.			
	3. If analytical procedures are used for substantive testing purposes, document the basis for the expected relationship, the results of the comparison of the recorded amount to the expectation, and the results of the evaluation of unexpected differences between the recorded amount and the expectation.			
	C. Other Auditing Procedures			
A	1. Where material, count cash on hand, reconcile balances on hand to required amounts and obtain signature of custodian acknowledging return of funds intact.			
A	2. Confirm year-end balances by direct correspondence with the banks for all bank accounts that were open during any part of the year, and obtain list of authorized check signers for permanent file.			
[A]	3. Obtain copies of client's bank reconciliations at the end of the year.			
A	4. Substantiate reconciling items as follows:			
	a. Whenever audit work is performed prior to the client receiving the bank statement, or whenever otherwise deemed appropriate, obtain directly from the bank, bank cutoff statements and related supporting documents.			
	b. Trace deposits in transit to subsequent bank statements and to cash receipts records. Examine the receipted deposit slip to determine whether the funds were deposited on, or prior to, the balance sheet date and whether there was any extraordinary delay between the date received per books and date deposited per bank.			
	c. Test checks dated on or before balance sheet date but clearing after the balance sheet date to determine that they appear on the list of outstanding checks.			
	d. Compare checks listed on the list of outstanding checks in excess of $__, including both those that have been subsequently paid and those that have not been paid, to the cash disbursements records as to amount.			
	e. Investigate the date of issuance for any large checks not cleared in the month following year-end. For those checks actually issued after the balance sheet date, record audit adjustments.			
	f. Trace any significant transfers between banks or accounts of a bank (including investment accounts) near year-end to verify both transactions have been recorded in the same accounting period.			
	g. Investigate any remaining significant reconciling items not covered above.			
A	5. Prepare proof(s) of cash for appropriate time periods. Substantiate any deposits in transit as outlined in 4(b) for all periods in which a proof of cash was prepared.			
[A]	6. Consider reversing old outstanding checks. (Investigate those over $______.)			
[A]	7. Review receipts, etc., issued shortly before and shortly after year-end to determine that all cash collected has been recorded in the proper period.			
C	8. Obtain copies of all collateral agreements the local government has with depositories and consider confirming the collateral with the bank or agency holding the collateral securities. Determine if the collateral complies with legal requirements and if the market value is adequate to secure the funds on deposit.			

Obj.		Done By	Date	W/P Ref.
C	9. Test collateralization throughout the year to determine its adequacy. Note instances in which the local government's uncollateralized deposits during the period significantly exceeded that category of credit risk at balance sheet date.	_____	_____	_____
C	10. Determine if deposits at any time during the year materially exceeded amounts on deposit as of the end of the year. Determine reasons for significant fluctuations (check here if reason is due to normal fluctuating cash flow requirements _____).	_____	_____	_____
A B	11. Identify which individual funds are required by law or other contractual agreement to maintain separate bank accounts and ascertain that separate bank accounts are maintained and note any withdrawal restrictions or other commitments which may exist.	_____	_____	_____
C [D]	12. Review client's classifications as to credit risk for note disclosure.	_____	_____	_____
	13. Make appropriate notations regarding matters to be discussed with audit partner, manager, or in-charge auditor.	_____	_____	_____
	D. Overall Conclusions			
	1. In our opinion, we have obtained sufficient and competent evidential matter to provide reasonable assurance that:			
	a. Cash balances as stated in balance sheet properly represent cash and cash items on hand, in banks or in transit;	_____	_____	_____
	b. Cash is properly classified in the financial statements and adequate disclosure (by segregation or otherwise) is made of restricted or committed funds and of cash not subject to immediate withdrawal and accounts with credit balances;	_____	_____	_____
	c. Deposits are properly classified as to credit risk as required by GASB Statement No. 3; and,	_____	_____	_____
	d. Applicable accounting principles have been consistently applied; Except as follows: ________________ ________________ ________________	_____	_____	_____

This audit program section has been completed in accordance with firm policy.

	Date
Done by ________________	________
Reviewed by ________________	________

[The next page is 5611.]

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Obj.		Done By	Date	W/P Ref.

.030 III. Investments

Financial Statement Assertions

1. Existence or occurrence
2. Completeness
3. Rights and obligations
4. Valuation or allocation
5. Presentation and disclosure

Audit Objectives

A. The physical evidence of ownership of investments reported in the financial statements (stock certificates, bonds, notes, etc.) are on hand or held in custody or safekeeping by others for account of the client.(Assertions 1, 2, and 3)

B. The basis on which the investments are stated is in accordance with generally accepted accounting principles, consistently applied. (Assertions 4 and 5)

C. Income from investments has been accounted for properly. (Assertions 4 and 5)

D. Investments and the related income are properly classified and described in the financial statements. (Assertions 4 and 5)

E. Adequate disclosure has been made of the pledging of any investments and credit risks are properly disclosed as required by GASB Statement No. 3. (Assertions 2, 3, and 5)

F. Investments are made in accordance with state and local laws and regulations. (Assertions 3 and 5)

G. Applicable accounting principles have been consistently applied. (Assertions 4 and 5)

Note: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

A. Evaluation of Internal Control Structure

1. Review the documentation and conclusion resulting from the steps taken to understand and test the internal control structure policies, procedures, and records relevant to planning the audit of investments. ____ ____ ____

Obj.		Done By	Date	W/P Ref.
	2. Consider the understanding obtained of the internal control structure, the assessed level of control risk (together with the assessment of inherent risk), and the acceptable level of detection risk to determine the nature, timing, and extent of substantive tests.	____	____	____
	3. Revise the audit program, as appropriate, following the consideration of the internal control structure and related audit risks.	____	____	____
	B. Analytical Procedures			
	1. Review the planning procedures applicable to analytical procedures performed on investments and consider the result of the procedures in determining the nature, timing, and extent of other audit procedures.	____	____	____
	2. Revise the audit program, as appropriate, following consideration of the results of the analytical procedures.	____	____	____
	3. If analytical procedures are used for substantive testing purposes, document the basis for the expected relationship, the results of the comparison of the recorded amount to the expectation, and the results of the evaluation of unexpected differences between the recorded amount and the expectation.	____	____	____
	C. Other Auditing Procedures			
[F]	1. Obtain an understanding of state and local investment laws and regulations.	____	____	____
[A] [D]	2. Obtain a list of investments owned showing location and identify ownership by fund.	____	____	____
A	3. Confirm or examine each security and compare with the list. Determine that the beginning and ending serial numbers are the same for all securities where there is no activity during the year.	____	____	____
[A]	4. Mail confirmations on securities held by others.	____	____	____
A [D]	5. Verify all changes between date of physical inspection and date of balance sheet.	____	____	____
C [D]	6. Test accrued interest to balance sheet date.	____	____	____
B C	7. Test amortization of premiums (or discount) paid, where applicable.	____	____	____
C [D]	8. Verify collections of interest.	____	____	____
D [G]	9. Obtain market values at balance sheet date and value of collateral and investigate significant differences from recorded values to determine if any write-downs are necessary.	____	____	____
F	10. Test investment transactions during the year to determine that investments are in accordance with statutory requirements (if applicable).	____	____	____
C [D]	11. Test interest revenue accounts in the various funds and reconcile interest income to the investment transactions.	____	____	____
[C] [D]	12. Select investment transactions, test the income thereon and trace to amounts recorded in the various funds.	____	____	____
C D	13. Verify that all investments and related income were applied to the proper fund of ownership.	____	____	____
E [G]	14. Review GASB Statement No. 3 disclosures:			
	a. Any significant violations of state statutes, local charters, resolutions or ordinances, grant regulation, or internal policies in the investment of local funds.	____	____	____
	b. Determine whether basis of valuation (e.g., cost, market value, or lower of cost or market value) is in accordance with GAAP, and that appropriate allowances and/or write-downs have been provided. (Especially treasury bills.)	____	____	____
	c. Any commitments at the balance sheet date to resell securities under yield maintenance repurchase agreements. Yes ____ No ____	____	____	____

Obj.		Done By	Date	W/P Ref.
	d. Determine types of investments made during the year but not owned as of the balance sheet date. For example: ______ State Investment Pool ______ Repurchase Agreement ______ Federal Securities ______ Other	_____	_____	_____
	e. Any reverse repurchase agreements used during the year. If yes, see GASB Statement No. 3. Yes ______ No ______	_____	_____	_____
E	15. Review client's classification of investments as to credit risk for note disclosure.	_____	_____	_____
E [G]	16. Review client's disclosure under GASB Statement No. 3 for overall adequacy.	_____	_____	_____
	17. Make appropriate notations regarding matters to be discussed with audit partner, manager, or in-charge auditor.	_____	_____	_____
F	18. Review minutes of governing body or investment committee for approval of transactions.	_____	_____	_____
F	19. Review for unusual transactions (high risk or churning).	_____	_____	_____
F G	20. Review management's intended holding period and liquidity requirements in the case of a decline in market value.	_____	_____	_____
[E] F [G]	21. Concerning repurchase agreements:			
	a. Review terms of outstanding repurchase commitments. Terms should include the types and coupon rate of collateral and the repurchase date and prices.	_____	_____	_____
	b. Consider reputation and reliability of collateral holders. Those holders should be bank or trust companies that are independent of the broker-dealer arranging the transaction and that specialize in providing safekeeping services.	_____	_____	_____
	c. Review the reputation and financial position of broker-dealers or other parties to the transaction.	_____	_____	_____
	d. Consider the financial credibility and legal responsibility of any company or agency that is insuring completion of the transaction.	_____	_____	_____
	e. Review broker's advices and other documentation regarding the completion of the repurchase transaction during the period following the balance sheet date.	_____	_____	_____
	f. Review and evaluate internal audit procedures covering repurchase agreement activities.	_____	_____	_____
A	22. If the client is a buyer/lender (and surrendered possession of the securities):			
	a. Examine securities held or request confirmation of securities held in safekeeping and determine who holds legal title to the securities.	_____	_____	_____
	b. If custodian is of uncertain or questionable reputation and reliability, obtain third party review or perform procedures concerning controls over the safekeeping of the security of the custodian.	_____	_____	_____
	c. Test collateral value of securities.	_____	_____	_____

D. Overall Conclusions

1. In our opinion, we have obtained sufficient and competent evidential matter to provide reasonable assurance that:

Obj.		Done By	Date	W/P Ref.
	a. The physical evidence of ownership of investments reported in the financial statements (stock certificates, bonds, notes, etc.) are on hand or held in custody or safekeeping by others for account of the client;	____	____	____
	b. The basis on which the investments are stated is in accordance with generally accepted accounting principles consistently applied;	____	____	____
	c. Income from investments has been accounted for properly;	____	____	____
	d. Investments and the related income are properly classified and described in the financial statements;	____	____	____
	e. Adequate disclosure has been made of the pledging or hypothecation of any investments and credit risks are properly disclosed as required by GASB Statement No. 3;	____	____	____
	f. Investments are made in accordance with state and local laws and regulations; and	____	____	____
	g. Applicable accounting principles have been consistently applied;	____	____	____
	Except as follows:			
	____________________			
	____________________			
	____________________	____	____	____

This audit program section has been completed in accordance with firm policy.

	Date
____________________	____________
Done by	
____________________	____________
Reviewed by	

> The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

Obj.		Done By	Date	W/P Ref.

.040 IV. Revenue and Receivables

Financial Statement Assertions

1. Existence or occurrence
2. Completeness
3. Rights and obligations
4. Valuation or allocation
5. Presentation and disclosure

Audit Objectives

A. Revenue accounts and related income and expense accounts include all transactions that relate to the period. (Assertions 1, 2, and 5)

B. Receivables are authentic and probably collectible. (Assertions 1 and 3)

C. Judgments on which valuations, allowances and deferred revenue are arrived at are rational and responsible. (Assertions 4 and 5)

D. Descriptions, classifications, and related disclosures are adequate and not misleading. (Assertion 5)

E. All loss contingencies related to revenue are identified and reported or disclosed. (Assertions 2, 3, and 5)

F. Applicable accounting principles have been applied consistently. (Assertions 4 and 5)

Note: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

A. Evaluation of Internal Control Structure

1. Review the documentation and conclusions resulting from the steps taken to understand and test the internal control structure policies, procedures, and records relevant to planning the audit of revenue and receivables. ____ ____ ____
2. Consider the understanding obtained of the internal control structure, the assessed level of control risk (together with assessment of inherent risk), and the acceptable level of detection risk to determine the nature, timing, and extent of substantive tests. ____ ____ ____
3. Revise the audit program, as appropriate, following the consideration of the internal control structure and related audit risks. ____ ____ ____

B. Analytical Procedures

Obj.		Done By	Date	W/P Ref.
	1. Review the planning procedures applicable to analytical procedures performed on revenue and receivables and consider the result of the procedures in determining the nature, timing, and extent of other audit procedures.	____	____	____
	2. Revise the audit program, as appropriate, following consideration of the results of the analytical procedures.	____	____	____
	3. If analytical procedures are used for substantive testing purposes, document the basis for the expected relationship, the results of the comparison of the recorded amount to the expectation, and the results of the evaluation of unexpected differences between the recorded amount and the expectation.	____	____	____
	C. Other Auditing Procedures—Revenues			
	1. General Property Taxes			
A [B]	a. Determine that the appropriate tax was properly levied.	____	____	____
	(1) Determine that property assessments have been made in compliance with laws.	____	____	____
	(2) Determine that property tax rates are in compliance with laws.	____	____	____
	(3) Determine that appropriate tax status (e.g., tax-exempt, commercial) has been applied.	____	____	____
[A] D	b. Confirm current tax settlements and trace tax distribution into funds.	____	____	____
[A] D	c. Determine that tax allocations among funds are in accordance with original levy.	____	____	____
A B D [F]	d. Confirm amounts of special or supplemental tax distributions and trace into proper funds, relating to:			
	(1) Back taxes collected.	____	____	____
	(2) Tax objections overruled.	____	____	____
A [B] C [E]	e. Compute adjustments to allowance for uncollectibles or deferred revenue accounts.	____	____	____
A [B]	f. Determine that property tax sales were properly authorized for nonpayment of taxes and the major receipts were properly recorded on a timely basis.	____	____	____
D	g. Determine that taxing policies and procedures are properly disclosed in the notes to the financial statements.	____	____	____
[A]	h. Determine that all properties are included in the tax roll.	____	____	____
	2. Sales, Income, or Other Taxes			
A B	a. Review the methods used by the local government to reasonably assure that all taxes due have been remitted (for example, systems providing for the cross-referencing of returns to a data base showing prior returns, registered corporations, etc.)	____	____	____
A [C]	b. Determine that proper accruals have been made to record sales, income, or other taxes held by other governments at fiscal year end.	____	____	____
A B	c. Evaluate the reasonableness of amounts estimated for income taxes receivable or refunds payable.	____	____	____
A	d. Select a sample of returns and verify that the tax liability was computed in accordance with governing laws and regulations and that related payments were deposited and properly recorded in the accounting records.	____	____	____
A B	e. Test year-end cutoff of recording self-assessed taxes.	____	____	____
	3. Revenue From Federal, State and County Agencies			
A B	a. Confirm revenue received from federal, state and county agencies directly with the appropriate agency.	____	____	____

Obj.		Done By	Date	W/P Ref.
A C	b. Determine that grant revenues earned based on expenditures are properly accrued.			
	c. Review significant grant applications and related monitoring and grant reports.			
A B C	d. Review minutes of legislative proceedings to identify grants received and their restrictions.			
	e. Review monitoring procedures used by management.			
	4. Licenses and Permits			
[A] [B]	a. Determine licenses and permits in effect and rates set by ordinance.			
	(1) On a test basis, trace collections from persons or businesses ordinarily required to pay fees to accounting records.			
A	b. Trace cash entries from license and permit stub books to cash receipts records on a test basis.			
A	c. Compare licenses and permit revenue by totals to previous year and explain any material variation.			
A	d. Reconcile inventories of licenses and permits to revenues where appropriate.			
A B	e. Review applications or renewal bills for proper charge, and trace collections to accounting records.			
	5. Franchise Fees			
A B	a. Review franchise ordinances and compare fees as indicated therein with amounts received.			
	6. Fines			
A B F	a. Review client's procedures for accounting for arrest tickets and determine that tickets are being properly disposed of through the collection of cash or authorized dismissal.			
A B C	b. Verify collection of fines.			
A	c. Compare fine revenue by totals to previous years and explain any material variation.			
A B	d. Determine that fines are distributed in accordance with governing regulations.			
	7. Utility or Other Enterprise Revenues			
B [A]	a. Examine rate schedules and authorization for charges.			
A B	b. Where charges are based on variable quantities or volume of usage, test records of usage such as meter reader reports.			
A B	c. Test computations of billings for a selected period, watching to see that authorized rates are in use, especially for local government officials and employees.			
A	d. Trace collections for a selected period into the accounts receivable subledger and cash receipts.			
A B	e. Determine reasonableness of enterprise revenues when compared to records showing the production of goods or services.			
	8. Sale of Property and Equipment			
B	a. Review minutes of corporate body for authority to sell property and equipment.			
A	b. Trace sale proceeds to cash receipts records.			
A	c. Determine that major dispositions have been removed from the property and equipment records.			
A	d. Determine that proceeds are credited to the proper fund as required by law and any receivables are properly classified.			

Obj.		Done By	Date	W/P Ref.
	9. Rentals of Property and Equipment			
A B	a. Examine authorizing laws and regulations, schedules, contracts, leases and other documents governing the use of public property by others.			
A B	b. On a test basis, compare the amounts of billings against terms of rental agreements.			
A	c. Trace collections into cash receipts for selected periods.			
	10. Special Assessments			
A	a. Trace collections of assessments, interest and penalties into cash receipts for selected periods.			
A D	b. Trace the public benefit portion of all assessments into the public benefit fund or debt service fund.			
D	c. On an overall basis determine that collections are being accounted for in the proper assessment roll.			
	11. Interfund Transfers			
D	a. Obtain or prepare a schedule of transfers between funds.			
D	b. Determine authorizations and amount of such transfers by review of the budget or minutes of the client's governing body.			
D [F]	c. Determine that all transfers are properly classified as operating or equity and reported accordingly in the financial statements.			
	12. Other Revenues			
A	a. Schedule any other revenue accounts of material amount and perform audit procedures determined necessary.			
[A] C	b. Review estimate of unbilled revenues and compare to subsequent billings.			
	D. Other Auditing Procedures—Receivables			
	1. All Receivables			
	a. If accounts receivables are not being confirmed, document the reason. One of the following is acceptable:			
	(1) Accounts receivable are immaterial to the financial statements.			
	(2) Use of confirmations would be ineffective.			
	(3) Combined assessed level of inherent and control risk is low (as noted in A(2), above) and the assessed level, in conjunction with other evidence (analytical procedures or other substantive tests), reduced audit risk to an acceptably low level for applicable financial statement assertions.			
	2. Property Taxes Receivable			
A B	a. Examine or obtain by confirmation the following:			
	(1) Assessed valuation for the tax levy year under review.			
	(2) Tax rates and tax extensions by fund.			
	(3) A listing by dates of property taxes distributed to the local government.			
D	b. Trace property tax levies and remittances to the various funds to determine that revenues were properly allocated to the appropriate funds in accordance with governing laws and regulations.			
A [C]	c. Where the local government records property tax remittances on the cash basis of accounting, determine at the end of the fiscal year that such revenue has been applied to the respective property tax receivable accounts, by tax levy years.			
A	d. Determine that the current tax levies, by funds, have been journalized to reflect the levy as a property tax receivable, and the credit to a revenue line item.			

Obj.		Done By	Date	W/P Ref.
[A] B	e. Review the tax rates, by funds, to determine that they do not exceed statutory limits.	____	____	____
[A] B	f. Review the tax extensions as computed by the county, and compare with the client's tax-levy ordinance.	____	____	____
C E	g. Review the adequacy of the provision for uncollectible taxes based on prior collection experience.	____	____	____
	3. Interfund Accounts			
A D	a. Obtain a schedule of all interfund and intrafund account balances.	____	____	____
A	b. Determine that they are in reciprocal balance.	____	____	____
B	c. Review minutes of local government and appropriate bond ordinances for authorization of interfund activity.	____	____	____
A D	d. Trace interfund transactions between funds and to underlying documentation.	____	____	____
A B C D	e. Review ending balances of accounts as to:			
	(1) Aging of balances.	____	____	____
	(2) Reason for transactions.	____	____	____
	(3) Method of liquidation anticipated.	____	____	____
	(4) Proper reporting classification.	____	____	____
	(5) Collectibility.	____	____	____
	4. Special Assessments Receivable			
A	a. Obtain a list of all assessments receivable balances and compare the total of these balances to the general ledger control accounts.	____	____	____
B	b. Verify on a test basis that the calculations for the installments receivables are correct.	____	____	____
A	c. Determine on a test basis that the proper amount of interest has been charged to outstanding assessment installments.	____	____	____
A B E	d. Consider confirmation of unpaid assessment balances directly with property owners, especially significant or old balances.	____	____	____
[A] C	e. Trace the deferred public benefit portion into the long-term debt account group.	____	____	____
B [E]	f. Review all adjustments to the accounts for authority.	____	____	____
B	g. Inquire as to any pending legal suits regarding bonds or vouchers.	____	____	____
	5. Other Receivables			
A B	a. Obtain a list of each type of receivable, such as from other governmental units or others:			
	(1) Sales taxes.	____	____	____
	(2) State income taxes.	____	____	____
	(3) Utility taxes.	____	____	____
	(4) Court fines.	____	____	____
	(5) Grants.	____	____	____
	(6) Motor fuel tax.	____	____	____
	(7) All other (employees, suppliers, citizens, etc.).	____	____	____
B C E	b. Obtain an aged listing of accounts receivable. Test the accuracy of the listing.	____	____	____
A	c. Reconcile balance with general ledger.	____	____	____
A B	d. Consider confirmation by mail of individual accounts with large balances.	____	____	____
A B C E	e. Obtain or list subsequent collections of past due items to date of examination.	____	____	____

Obj.		Done By	Date	W/P Ref.
B E	f. Review uncollectible accounts written off for authority and propriety.			
B E	g. Review uncollectibility of accounts with responsible personnel and determine proper allowance is established for possible uncollectible accounts.			
B E	h. Review all large credits issued during the year.			
A	i. Cross check between the receivable account and the related revenue account.			
	E. Other Auditing Procedures—Cash Receipts			
A	1. Foot and cross-foot cash journal for a selected period and trace totals to ledger accounts.			
A	2. See that cash receipts are deposited intact and timely up to the date the audit is made, or for a selected sample thereof, that is, that each day's deposits are equal to the previous day's receipts.			
	F. Overall Conclusions			
	1. In our opinion, we have obtained sufficient and competent evidential matter to provide reasonable assurance that:			
	a. Revenue accounts and related income and expense accounts include all transactions that relate to the period;			
	b. Receivables are authentic, properly classified, and probably collectible;			
	c. Judgments on which valuations, allowances and deferred revenue are based are arrived at rationally and responsibly;			
	d. Descriptions, classifications and related disclosures are adequate and not misleading;			
	e. All loss contingencies related to the revenue cycle are identified and recorded or disclosed; and,			
	f. Applicable accounting principles have been consistently applied.			

This audit program section has been completed in accordance with firm policy.

	Date
Done by	
Reviewed by	

> The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

Obj.		Done By	Date	W/P Ref.

.050 V. Expenditures, Expenses, and Payables

Financial Statement Assertions

1. Existence or occurrence
2. Completeness
3. Rights and obligations
4. Valuation or allocation
5. Presentation and disclosure

Audit Objectives

A. Expenditure/expense accounts include all costs and expenses applicable to the period and all losses and estimated future expenses that should be reflected in the period, and that classification is consistent with the accounting system and generally accepted accounting principles. (Assertions 1, 2, 4, and 5)

B. Amounts payable are properly authorized, represent the correct amounts of currently payable items and reflect all outstanding obligations. (Assertions 2, 3, and 5)

C. Prepaid and accrued accounts are properly stated. (Assertion 4)

D. Account descriptions, classifications and related disclosures are adequate and not misleading. (Assertion 5)

E. All loss contingencies are identified and recorded or disclosed. (Assertions 2, 3, and 5)

F. Legal requirements relating to purchasing, payrolls, and disbursements have been complied with. (Assertion 3)

Note: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

A. Evaluation of Internal Control Structure

1. Review the documentation and conclusions resulting from the steps taken to understand and test the internal control structure policies, procedures, and records relevant to planning the audit of expenditures. ____ ____ ____
2. Consider the understanding obtained of the internal control structure, the assessed level of control risk (together with assessment of inherent risk), and the acceptable level of detection risk to determine the nature, timing, and extent of substantive tests. ____ ____ ____
3. Revise the audit program, as appropriate, following the consideration of the internal control structure and related audit risks. ____ ____ ____

B. Analytical Procedures

Obj.		Done By	Date	W/P Ref.
	1. Review the planning procedures applicable to analytical procedures performed on expenditures of cash and consider the result of the procedures in determining the nature, timing, and extent of other audit procedures.			
	2. Revise the audit program, as appropriate, following consideration of the result of the analytical procedures.			
	3. If analytical procedures are used for substantive testing purposes, document the basis for the expected relationship, the results of the comparison of the recorded amount to the expectation, and the results of the evaluation of unexpected differences between the recorded amount and the expectation.			
	C. Other Auditing Procedures—Expenditures/Expenses			
	1. **General—For Selected Expenditures/Expenses** (excluding payroll expenditures), perform the following procedures:			
A [B] [C] F	a. Examine supporting documents and compare to disbursement records noting:			
	(1) Authorization for disbursement and approval of supporting document.			
	(2) Data supporting invoice such as purchase order and receiving report.			
	(3) Evidence of check of clerical accuracy.			
	(4) Cancellation of document.			
	(5) Duplicate payment of billing whole or in part.			
	(6) That payment of bill when entered on disbursement or purchase record was charged to proper expenditure and appropriation account or reserve for encumbrances.			
	(7) That appropriation balance was sufficient to receive charge for expenditures.			
	(8) Authorized check signer.			
	(9) That discounts were taken when offered.			
	(10) That purchase was recorded in the period received.			
	2. **Disbursements**			
[A]	a. Observe control over blank checks.			
[A]	b. Review disbursements journal for period under audit for unusual items.			
	3. **Appropriations**			
F	a. Determine that reported budget amounts are supported by original adopted appropriations adjusted for properly authorized budget amendments.			
[A] F	b. Examine budget for the year under audit and determine if related expenditures plus encumbrances are within the appropriations.			
F	c. Determine if the appropriation ordinances comply with governing legal provisions and relate directly to tax levy ordinances			
	4. **Purchases**			
[B] D F	a. Review the applicable ordinance or regulation setting forth the procedure for making purchases, and determine that selected purchases were made or awarded in accordance with these regulations. Bid files should be examined on a test basis for those purchases for which competitive bids are required.			
A B	b. Check invoice for correct price and accuracy of mathematics.			
A B	c. Compare purchase order, receiving report and invoice.			
A	d. Note purchases from local government officials or employees.			

Obj.		Done By	Date	W/P Ref.
	5. Payrolls—For Selected Payroll Disbursements, Perform the Following Procedures:			
F	a. Compare the rates of pay shown on the individual payroll records and on the payroll summaries with the salary and appropriation ordinances.			
[A] F	b. Examine time cards for approval.			
A B D	c. Determine that payroll amounts on the payroll records are charged to proper appropriation accounts and that amounts are recorded on individual payroll records.			
A B [F]	d. Distribute the payroll checks for any pay period, maintaining control over unclaimed checks until all have been claimed by authorized personnel.			
B	e. Compare payroll amounts with timekeeping or attendance records.			
A B F	f. Pay special attention to endorsements on payroll checks, noting especially those checks cashed by any department of the local government and investigate thoroughly.			
[D] F	g. Verify payment of the various payroll deductions to the proper authority.			
[A]	h. For selected employees, verify that appropriate entries were made to the client's leave records.			
D	i. Determine if client has a deferred compensation plan. If a plan exists, obtain required information for agency fund and footnote disclosure.			
D	j. Determine if local government pays post-retirement health care of life insurance costs. Obtain description of policies and related costs for current year.			
	6. Other Payroll			
A B	a. Review for retroactive pay increases, large overtime payments, and other unusual compensation arrangements.			
F	b. Review pay rates for compliance with policies or labor contract provisions.			
	7. Bond and Interest Expenditures/Expenses			
A B D F	a. Examine bond ordinances and tax levies for retirement of bonds and interest provisions and other material requirements and test compliance therewith.			
	(1) Prepare a statement of general bonded debt to determine that taxes to be received in the future will be adequate to retire all bonds and meet interest payments due.			
A B	b. Examine cancelled bonds and interest coupons making sure that all are properly cancelled, and reconcile to payments made.			
A	c. If bonds are registered, confirm with paying agents the receipt of advances shown as having been made by the local government and also the bonds and interest coupons paid and cancelled by paying agency during the year.			
	(1) Schedule the cash transactions carried on by paying agent's office and make a part of working papers.			
	8. Construction and Improvement Expenditures			
A B F	a. Check the minutes for action taken by the governing board pertaining to construction or bond ordinances where applicable.			
C D	b. Where federal, state or local government monies are used, check any regulatory laws or regulations issued by that governmental authority.			

Obj.		Done By	Date	W/P Ref.
E F	c. Determine that amounts paid are in accordance with the terms of contracts.			
A D	d. Ascertain amounts of contracts payable which are due but unpaid.			
A F	e. Review bids, contracts, partial payments, changes in orders, etc., in connection with major construction.			
F	f. Note purchases from local government officials or employees.			
A D	g. Trace in-house construction work orders to closing and transfer to GFAAG.			
	9. Trust and Agency Fund Expenditures and Disbursements			
D	a. Trace collections into trust and agency funds of the local government on a test basis.			
A D	b. Note and examine the properly filed reports supporting payments to other governmental agencies.			
A B F	c. For client employee retirement contributions, in addition to the steps noted above, confirm the amount of the local government's actuarial liability to that organization. Also, for any pension funds compute statutory liability.			
	10. Other Expenditures/Expenses			
A B	a. Determine that expenditures/expenses made by or on behalf of key officers are reasonable.			
A	b. Schedule any other expenditure or expense accounts of material amount and perform audit procedures determined necessary.			
	D. Other Auditing Procedures—Liabilities			
	1. Accounts or Vouchers Payable and Encumbrances			
	a. Obtain schedule of accounts payable and encumbrances at end of audit period. Consider confirmation of large accounts payable balances and trace encumbrances to unfilled purchase orders.			
A	b. Reconcile detail of liabilities to general ledger accounts.			
B	c. For selected entries in accounts payable examine underlying documentation.			
A B	d. Examine invoices received and payments made subsequent to year-end on a test basis to determine if any should be included in period being audited.			
A B	e. Ascertain nature and extent of unencumbered purchase commitments at year end.			
	2. Deposits			
C	a. Obtain and reconcile detailed records to general ledger.			
C	b. Confirm balances on a test basis.			
C	c. If interest is paid, test payments made of interest or interest accrued as of end of period being audited.			
C F	d. Review the provisions of any related ordinances and test for compliance.			
A C	e. Determine whether deposits are refundable in full or in part.			
[F]	f. Determine whether records of "bid" or "good faith" deposits are made.			
	3. Taxes Levied or Collected for Other Units of Government			
B	a. Verify collections, payments and balances on hand and collected balances due other units.			
B D	b. Determine that such items are recorded as liabilities to others.			

Obj.		Done By	Date	W/P Ref.
	4. Accrued Salaries and Wages			
B C F	a. If the client accrues salaries and wages and payroll taxes, the accuracy of such accruals should be verified. (Do accruals relate to budget provisions?)	____	____	____
	5. Taxes or Fees Collected in Advance			
A B	a. If taxes, licenses or fees have been collected in advance, they should be recorded as deferred revenue. Verify these amounts with reference to supporting documents and consider confirmation of amounts.	____	____	____
B D	b. Set up as a liability, duplicate tax or fee collection not disposed of.	____	____	____
B C	c. Trace disposition of items recorded at beginning of period.	____	____	____
	6. Compensated Absences			
	a. Obtain the local government's personnel policies and procedures and review the provisions relating to the accrual and payment of compensated absences.	____	____	____
A B [C] D	b. Obtain the schedule prepared by the local government to compute the liabilities for compensated absences and determine by appropriate tests that:			
	(1) The schedule is arithmetically correct;	____	____	____
	(2) All qualifying employees are included and that all employees included on the schedule are qualified;	____	____	____
	(3) Appropriate salary and benefit rates are applied;	____	____	____
	(4) Leave balances shown by the schedule are consistent with selected employee leave records; and	____	____	____
	(5) The schedule is correct as to the employing fund.	____	____	____
A D	c. Determine that the current and long-term portions of the liability have been recorded in accordance with GASB Codification section C60.	____	____	____
E	7. Review client's file concerning litigation, including attorney's invoices received during and after the period under audit.	____	____	____
E	8. Inquire as to material commitments to purchase or construct property, equipment, etc.	____	____	____
	E. Other Auditing Procedures—Prepaid Items			
[C]	1. Summarize the type and amount of other assets and prepaid items such as:			
	a. Unexpired insurance.	____	____	____
	b. Prepaid rent.	____	____	____
	c. Supplies inventories.	____	____	____
	d. Advances.	____	____	____
	e. Unamortized expense.	____	____	____
	f. Deposits.	____	____	____
	g. Other (itemize).	____	____	____
C	2. Ascertain propriety of amounts by review of calculations, supporting documents, related expense accounts, etc.	____	____	____
C	3. Confirm when considered necessary.	____	____	____
	F. Other Auditing Procedures—Cash Disbursements			
[A] [B]	1. Foot and cross-foot cash journals for a selected period and trace totals to ledger accounts.	____	____	____
A	2. Account for all checks issued or voided.	____	____	____

Obj.		Done By	Date	W/P Ref.
A	3. Examine checks issued during period being audited or for a selected sample thereof, for the following:			
	a. Entry to cash disbursement's records as to number, date, payee and amount.	____	____	____
	b. Authorization of governing body for issuance.	____	____	____
	c. Check signers and cosigners.	____	____	____
	d. Inspect endorsments and signatures.	____	____	____
	G. Overall Conclusions			
	1. In our opinion, we have obtained sufficient and competent evidential matter to provide reasonable assurance that:			
	a. Expenditure/expense accounts include all costs and expenses applicable to the period and all losses and estimated future expenses that should be reflected in the period and that classification is consistent with the accounting system and generally accepted accounting principles;	____	____	____
	b. Accounts payable are properly authorized, represent the correct amounts of currently payable items and reflect all outstanding obligations;	____	____	____
	c. Prepaid and accrued accounts are properly stated;	____	____	____
	d. Account descriptions, classifications and related disclosures are adequate and not misleading;	____	____	____
	e. All loss contingencies are identified and recorded or disclosed; and,	____	____	____
	f. Legal requirements relating to purchasing, payrolls, and disbursements have been complied with;			
	Except as follows:			
	______________________________			
	______________________________			
	______________________________	____	____	____

This audit program section has been completed in accordance with firm policy.

	Date
Done by ____________________	__________
Reviewed by ____________________	__________

The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

Obj.		Done By	Date	W/P Ref.

.060 VI. Inventories

Financial Statement Assertions

1. Existence or occurrence
2. Completeness
3. Rights and obligations
4. Valuation or allocation
5. Presentation and disclosure

Audit Objectives

A. Inventories physically exist, in good condition, unencumbered by pledge or lien. (Assertions 1, 2, and 3)

B. The accounts reflect all inventory held for sale in the ordinary course of operations. (Assertions 3 and 5)

C. Estimates of realizable value are carefully and consistently made. (Assertion 4)

Note: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

A. Evaluation of Internal Control Structure

1. Review the documentation and conclusions resulting from the steps taken to understand and test the internal control structure policies, procedures, and records relevant to planning the audit of inventories. ______ ______ ______
2. Consider the understanding obtained of the internal control structure, the assessed level of control risk (together with assessment of inherent risk), and the acceptable level of detection risk to determine the nature, timing, and extent of substantive tests. ______ ______ ______
3. Revise the audit program, as appropriate, following the consideration of the internal control structure and related audit risks. ______ ______ ______

B. Analytical Procedures

1. Review the planning procedures applicable to analytical procedures performed on inventory and consider the result of the procedures in determining the nature, timing, and extent of other audit procedures. ______ ______ ______
2. Revise the audit program, as appropriate, following the consideration of the results of the analytical procedures. ______ ______ ______
3. If analytical procedures are used for substantive testing purposes, document the basis for the expected relationship, the results of the comparison of the recorded amount to the expectation, and the results of the evaluation of unexpected differences between the recorded amount and the expectation. ______ ______ ______

Obj.		Done By	Date	W/P Ref.
	C. Other Auditing Procedures			
A	1. Observe the taking of physical inventories and make test counts of various items. Record quantities and description of items selected for test counts.	____	____	____
C	2. Ascertain that obsolete and damaged stock has been appropriately identified and valued.	____	____	____
B	3. Ascertain that proper cut-off is effected with respect to purchases and consumption.	____	____	____
A	4. Trace quantities and descriptions per audit test counts into final inventory sheets.	____	____	____
B	5. Test clerical accuracy of inventories as to:			
	a. Unit prices.	____	____	____
	b. Extensions.	____	____	____
	c. Footings.	____	____	____
	d. Totals to summaries.	____	____	____
[B] C	6. Select several items included in the inventory test counts and verify prices to determine that the inventory has been consistently valued.	____	____	____
B C	7. Compare the dollar amount of inventory by fund to prior periods and investigate any material fluctuations considering the reasonableness of the change in relation to the expected change.	____	____	____
B	8. Compute and analyze turnover rates for significant inventories.	____	____	____
	9. Make appropriate notations regarding matters to be discussed with audit partner, manager, or in-charge auditor.	____	____	____
	D. Overall Conclusions			
	1. In our opinion, we have obtained sufficient and competent evidential matter to provide reasonable assurance that:			
	a. Inventories physically exist, in good condition, unencumbered by pledge or lien;	____	____	____
	b. The accounts reflect all inventory held for sale in the ordinary course of operations;	____	____	____
	c. Cost of inventory items is measured in accordance with generally accepted accounting principles, consistently applied; and	____	____	____
	d. Estimates of realizable value are carefully and consistently made;			
	Except as follows:			
	____			
	____			
	____	____	____	____

This audit program section has been completed in accordance with firm policy.

	Date
Done by ____	____________
Reviewed by ____	____________

> The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

Obj. | Done By | Date | W/P Ref.

.070 VII. Property (for proprietary type funds, use Audit Program in AAM section 5400.090-.095)

Financial Statement Assertions

1. Existence or occurrence
2. Completeness
3. Rights and obligations
4. Valuation or allocation
5. Presentation and disclosure

Audit Objectives

A. The property represented by the account exists, is owned by the local government, and is unencumbered except as indicated. (Assertions 1 and 3)

B. Additions have been properly recorded, are recorded at the proper amount and are authentic. (Assertions 2, 4, and 5)

C. The basis of recording property is in accordance with generally accepted accounting principles. (Assertions 4 and 5)

D. Accounting for the use and disposition of property is consistent from period to period and is in accordance with generally accepted accounting principles. (Assertions 4 and 5)

E. The control over general fixed assets has properly been established. (Assertion 1)

NOTE: The letters preceding each of the above objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

A. Evaluation of Internal Control Structure

1. Review the documentation and conclusions resulting from the steps taken to understand and test the internal control structure policies, procedures, and records relevant to planning the audit of property. _____ _____ _____
2. Consider the understanding obtained of the internal control structure, the assessed level of control risk (together with assessment of inherent risk), and the acceptable level of detection risk to determine the nature, timing, and extent of substantive tests. _____ _____ _____
3. Revise the audit program, as appropriate, following the consideration of the internal control structure and related audit risks. _____ _____ _____

B. Analytical Procedures

1. Review the planning procedures applicable to analytical procedures performed on property and consider the result of the procedures in determining the nature, timing, and extent of other audit procedures. _____ _____ _____
2. Revise the audit program, as appropriate, following consideration of the results of the analytical procedures. _____ _____ _____

Obj.		Done By	Date	W/P Ref.
	3. If analytical procedures are used for substantive testing purposes, document the basis for the expected relationship, the results of the comparison of the recorded amount to the expectation, and the results of the evaluation of unexpected differences between the recorded amount and the expectation.			
	C. Other Auditing Procedures			
A [B] C E	1. When detailed records are maintained, the auditor should test by physical inspection that items are on hand and that the detailed property records are in agreement with the appropriate control accounts.			
B [C] E	2. Examine invoices or other documentation for additions to the fixed assets during the period. Determine if the additions have been authorized, classified in the accounts correctly and added to the property records. Determine capitalization policy regarding amounts.			
C D [E]	3. Test to determine that disposals were authorized and properly recorded in the property records and trace proceeds into the record of cash receipts or receivables.			
DE	4. For construction work-in-progress, obtain or prepare an analysis by project, test mathematical accuracy, examine documentary support for major additions, test transfers to permanent assets at end of year. Consider confirming status of construction contracts with contractors.			
[A] E	5. Review insurance policies to determine if property and equipment coverage is adequate.			
B	6. Test that all major repairs, additions and replacements have been authorized by the governing body, if legally required.			
B C	7. Review allowances for depreciation if the local government maintains such records (most local governments do not keep such records, except where an Enterprise Fund or Internal Service Fund is involved).			
A [B]	8. Examine deeds on newly acquired real estate and inquire into status of records for deeds on property acquired in prior periods.			
	9. Observe physical safeguards.			
[A] E	10. Make appropriate notations regarding matters to be discussed with audit partner, manager, or in-charge auditor.			
	D. Overall Conclusions			
	1. In our opinion, we have obtained sufficient and competent evidential matter to provide reasonable assurance that:			
	a. The property represented by the accounts exists, is owned by the local government and is unencumbered except as indicated;			
	b. Additions are properly recorded, are recorded at the proper amount, and are authentic;			
	c. The cost or other basis of recording property is in accordance with generally accepted accounting principles;			
	d. Accounting for the use and disposition of property is consistent from period to period and in accordance with the generally accepted accounting principles; and,			
	e. The control over general fixed assets has been properly established.			

This audit program section has been completed in accordance with firm policy.

	Date
Done by	
Reviewed by	

The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

Obj.		Done By	Date	W/P Ref.

.080 VIII. Financing (Including Equity Accounts)

Financial Statement Assertions

1. Existence or occurrence
2. Completeness
3. Rights and obligations
4. Valuation or allocation
5. Presentation and disclosure

Audit Objectives

A. All financing commitments, both those connected with recorded financing (assets pledged, covenants, etc.) and those related to prospective or "off-balance-sheet" financing, are identified. (Assertions 1 and 2)

B. All financing commitments are properly authorized and classified. (Assertions 2, 3, and 5)

C. All transactions are recorded in the correct period and amount. (Assertions 2 and 4)

D. The cost of financing is accounted for in accordance with generally accepted accounting principles. (Assertions 4 and 5)

E. All changes in equity accounts are properly recorded. (Assertions 2, 4, and 5)

F. All equity balances are properly reported. (Assertions 2 and 5)

G. If the government is subject to the rebate calculation and refund requirements of the Tax Reform Act of 1986 (TRA): (Assertion 3)

   a. The calculation has been made as required by law or regulation (annually on the anniversary date of each bond issue);

   b. The refund has been made as required (30 days after the end of the fifth rebate year); and

   c. Liabilities resulting from a failure to comply with rebate and refund requirements have been properly recorded as a loss contingency and/or disclosure has been made in the notes of potential loss of tax-exempt status.

NOTE: The letters preceding each of the above objectives serve as identification codes. These Codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

A. Evaluation of Internal Control Structure

1. Review the documentation and conclusions resulting from the steps taken to understand and test the internal control structure policies, procedures, and records relevant to planning the audit of financing. _____ _____ _____

Obj.		Done By	Date	W/P Ref.
	2. Consider the understanding obtained of the internal control structure, the assessed level of control risk (together with assessment of inherent risk), and the acceptable level of detection risk to determine the nature, timing, and extent of substantive tests.			
	3. Revise the audit program, as appropriate, following the consideration of the internal control structure and related audit risks.			
	B. Analytical Procedures			
	1. Review the planning procedures applicable to analytical procedures performed on financing and consider the result of the procedures in determining the nature, timing, and extent of other audit procedures.			
	2. Revise the audit program, as appropriate, following consideration of the results of the analytical procedures.			
	3. If analytical procedures are used for substantive testing purposes, document the basis for the expected relationship, the results of the comparison of the recorded amount to the expectation, and the results of the evaluation of unexpected differences between the recorded amount and the expectation.			
	C. Other Auditing Procedures—Notes, Tax Anticipation Warrants and Contracts Payable			
[A] B C	1. Determine that all obligations of this nature have been properly authorized. Schedule and verify changes in all obligation accounts for the year.			
[A] B C	2. Circularize note holders. Determine interest rates, collateral, liens, and security agreements, if any.			
B C D	3. Determine that warrants, etc., have not been issued in excess of legal limitations and confirm that payments have been made in accordance with legal requirements.			
C	4. Determine that interest paid or accrued has been computed correctly.			
B C	5. Determine any amount of retainage on construction billings in situations where construction projects are present. Examine contracts for proper authority.			
[A] B C	6. Determine that leases have been properly classified as capital or operating.			
	D. Other Auditing Procedures—Loans and Advances			
B C	1. Determine that all obligations of this nature have been properly authorized. Schedule and verify changes in all obligation accounts for the year.			
C D	2. Trace receipts to cash receipts.			
C D	3. Determine that all items are properly recorded as liabilities.			
C	4. Determine that all payments have been made as required.			
C [D]	5. Verify interest rates and accruals.			
	E. Other Auditing Procedures—Bonded Debt			
A B	1. Review bond register showing bonded debt.			
B	2. Check amounts authorized to records of election ordinances authorizing new issues in the current period.			
B C	3. Trace proceeds of new bond issues to bank account using broker's confirmation as a source of verification. Account for unissued bonds, if applicable.			
C D	4. Reconcile bond issues at beginning of period and at end of period.			
C D	5. Test interest expense for period and scrutinize it for any indication of unrecorded long-term debt.			
C D	6. Verify bonds and coupons due but not paid with paying agent where appropriate.			

Obj.		Done By	Date	W/P Ref.
B	7. Determine compliance with bond ordinance requirements for establishment and maintenance of restrictive accounts.	____	____	____
C	8. Verify payment of current year's maturities. (Examine cancelled bonds and interest coupons.)	____	____	____
C D	9. Confirm directly with the paying agent any year-end balances (including cancelled bonds and coupons on hand); that each issue has been serviced properly; and that the client has complied with all necessary requirements during the year.	____	____	____
C D	10. Determine that cash on hand with the paying agent is recorded as both an asset and a liability.	____	____	____
B	11. Review underlying documentation for any other long-term debt.	____	____	____
B	12. Determine that the total outstanding debt does not exceed the legal restrictions.	____	____	____
	F. Other Auditing Procedures—Other Debt			
B	1. Review documentation supporting compliance with debt covenants. Review for waiver in case of noncompliance.	____	____	____
B	2. Review calculation of debt limits compared to outstanding debt.	____	____	____
	G. Other Auditing Procedures—Arbitrage Rebate and Refund Requirements Under the Tax Reform Act of 1986			
G	1. Obtain a listing of obligations issued since August 15, 1986, the effective date of 1986 TRA.	____	____	____
G	2. Obtain for each bond issue the certificate as to arbitrage issued by bond counsel which is essential for an understanding of the compliance requirements relative to a bond issue.	____	____	____
G	3. Determine whether:			
	a. The foregoing bonds are subject to arbitrage rebate calculation and refund requirements of the TRA;	____	____	____
	b. The procedures adopted to ensure compliance with the arbitrage provisions of TRA are adequate. Consideration should be given to whether competent guidance has been received in this area from counsel and others;	____	____	____
	c. Accounting records are maintained by debt issue for proceeds, related investment earnings, and related rebate amounts, if any;	____	____	____
	d. Debt proceeds and bond issue reserve funds have been invested and the nature of the investment. Income on State and Local Government Series (SLGS) Program investments and income on tax exempt obligations will, as a general rule, be exempt from arbitrage;	____	____	____
	e. The arbitrage rebate calculation has been made annually on the bond issue anniversary date and whether the rebate amount has been placed in a separate account. The rebate calculation is generally made through the use of purchased software or by consultants;	____	____	____
	f. The appropriate rebate refund payment was made to the U.S. Treasury within 30 days after the end of the fifth rebate year. The rebate payment must be:	____	____	____
	(1) 90% of the calculated rebate amount, and	____	____	____
	(2) All interest earned on the rebate amount;	____	____	____
	g. Any penalties have been imposed by the Internal Revenue Service for failure to comply with the TRA;	____	____	____
	h. The government has been advised of the possible loss of tax exempt status on bond issues for failure to comply with the provisions of the TRA; and,	____	____	____
	i. The rebate amount and penalties, if any, are properly reported in the financial statements and/or disclosed in the notes thereto.	____	____	____

Obj.		Done By	Date	W/P Ref.
G	4. Determine whether the local government's record retention policy requires records to be maintained for 6 years after the bonds are retired.	____	____	____
	H. Other Auditing Procedures—Local Government Entity			
A	1. Sinking fund requirement and reserves.			
	a. Examine the statutes, charter or ordinance with respect to the method of calculating annual sinking fund and reserve requirements.	____	____	____
	b. Determine that the reserve for retirement of sinking fund bonds is set-up on a basis provided by law. If there are no legal provisions respecting the basis of calculating requirements, see that such requirements are set-up on an actuarial basis.	____	____	____
	c. Note whether the reserve indicates correctly the amount of assets which should be in the fund.	____	____	____
	d. Note whether contributions and earnings thereon are in accordance with requirements.	____	____	____
	e. Determine that restricted assets are invested in the classes of securities as required by law, if applicable.	____	____	____
	f. Determine that sinking fund investments mature early enough to meet the bonds to be retired from the fund.	____	____	____
E F	2. Fund balances, retained earnings, reserves, and designations.			
	a. Review the minutes of the governing body, boards, charter, and debt agreements to identify the authorizations for reservations or designations of fund balances. Determine that such reserves and designations are properly recorded and disclosed.	____	____	____
	b. Review balances for legal compliance.	____	____	____
	c. Analyze all transactions to the reserve accounts for the year.	____	____	____
	d. Analyze all transactions to fund balances or retained earnings accounts for the year to determine that all such transactions are properly reported in the financial statements or notes.	____	____	____
	e. Verify the validity of any adjustment to the fund balance or, where applicable, retained earnings accounts, and determine appropriate reporting if material.	____	____	____
	I. Overall Conclusions			
	1. In our opinion, we have obtained sufficient and competent evidential matter to provide reasonable assurance that:			
	a. All financing commitments, both those connected with recorded financing and those related to prospective or "off balance-sheet" financing are identified;	____	____	____
	b. All financing commitments are properly authorized and classified;	____	____	____
	c. All transactions are recorded in the correct period and amount;	____	____	____
	d. The cost of financing is accounted for in accordance with generally accepted accounting principles;	____	____	____
	e. All changes in equity accounts are properly recorded;	____	____	____
	f. All equity balances are properly reported;	____	____	____
	g. The arbitrage rebate calculation, if required, has been made as required by law/regulation;	____	____	____
	h. The arbitrage refund has been made as required by law/regulation; and,	____	____	____

Obj.		Done By	Date	W/P Ref.
	i. There are no loss contingencies due to noncompliance that have not been properly recorded or disclosed. Except as follows: __________ __________ __________	____	____	____

This audit program section has been completed in accordance with firm policy.

	Date
Done by	
Reviewed by	

[The next page is 5637.]

The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

Obj.		Done By	Date	W/P Ref.

.090 IX. Insurance

Financial Statement Assertions

1. Existence or occurrence
2. Completeness
3. Rights and obligations
4. Valuation or allocation
5. Presentation and disclosure

Audit Objectives

A. The local government has provided reasonable coverage for risks of loss. (Assertion 3)

B. Self-insurance programs are properly authorized and in accordance with state and local laws and regulations. (Assertion 3)

C. Self-insurance program premiums have been properly assessed and recorded in benefiting funds. (Assertions 3, 4, and 5)

D. Claims payable for self-insurance programs have been properly determined and recorded. (Assertions 2, 3, 4, and 5)

E. Claims paid by self-insurance programs conform to self-insurance program requirements. (Assertion 3)

F. Note disclosures relative to the local government's insurance programs provide adequate disclosure. (Assertion 5)

NOTE: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

A. Evaluation of Internal Control Structure

1. Review the documentation and conclusions resulting from the steps taken to understand and test the internal control structure policies, procedures, and records relevant to planning the audit of insurance. ____ ____ ____
2. Consider the understanding obtained of the internal control structure, the assessed level of control risk (together with assessment of inherent risk), and the acceptable level of detection risk to determine the nature, timing, and extent of substantive tests. ____ ____ ____
3. Revise the audit program, as appropriate, following the consideration of the internal control structure and related risks. ____ ____ ____

B. Analytical Procedures

1. Review the planning procedures applicable to analytical procedures performed on cash and consider the result of the procedures in determining the nature, timing, and extent of other audit procedures. ____ ____ ____

Obj.		Done By	Date	W/P Ref.
	2. Revise the audit program, as appropriate, following consideration of the results of the analytical procedures.			
	3. If analytical procedures are used for subtstantive testing purposes, document the basis for the expected relationship, the results of the comparison of the recorded amount to the expectation, and the results of the evaluation of unexpected differences between the recorded amount and the expectation.			
	C. Other Auditing Procedures			
A	1. Obtain a copy of the local government's insurance register.			
A	2. Verify the accuracy of the insurance register by comparing the referenced policy information to the insurance policy.			
A	3. Determine that the insurance register is complete by comparing recorded premium payments to the insurance policies shown by the insurance register. Trace covered property to the property records.			
A B [F]	4. Prepare a schedule showing the types of risks of loss to which the local government is exposed and how those risks are handled (for example, through commercial insurance, self-insurance, public risk pool, etc.).			
B	5. Where applicable, review local government resolutions, minutes, state statutes, etc., authorizing the retention of risk (self-insurance program).			
C D	6. For self-insurance programs accounted for within an internal service fund, determine that premiums are:			
	a. Recorded as charges for services in the internal service fund;			
	b. Recorded as expenditures/expenses of the insured funds; and,			
	c. Based on the loss experience of the internal service fund and allocated to the insured funds on a reasonable basis.			
D E	7. Determine that claims and related expenditures/expenses have been recognized in accordance with GASB Codification section C50. Claims payable may be estimated through a case-by-case review of all claims, the application of historical experience to the outstanding claims, or a combination of those methods.			
D	8. Determine that the estimated liability includes INBR losses and that the basis used to establish such estimates is reasonable.			
D F	9. Determine that the liability has been properly recorded and reported:			
	a. For the general fund, claims payable are recorded using the modified accrual basis, with the current portion recorded as an expenditure and a fund liability and the long-term portion recorded in the general long-term debt account group.			
	b. For internal service funds, the total of claims payable are reported as internal service funds liabilities.			
E	10. Select a representative sample of claims paid and verify that the claimed losses were documented and that the payments made conform to program provisions.			
E	11. Examine claims paid subsequent to the close of the fiscal year to determine the existence of unrecorded payables.			
C	12. Determine that consideration has been given to recording properly authorized interfund receivables and payables to eliminate internal service fund deficits.			
C	13. Determine that assets accumulated to pay claims are appropriately shown as reserved or designated for self insurance.			
F	14. Determine the accuracy and completeness of related note disclosures.			

Obj.		Done By	Date	W/P Ref.
	D. Overall Conclusions			
	1. In our opinion, we have obtained sufficient and competent evidential matter to provide reasonable assurance that:			
	a. The local government has provided reasonable coverage for risks of loss;	_____	_____	_____
	b. Self-insurance programs are properly authorized and in accordance with state and local laws and regulations;	_____	_____	_____
	c. Self-insurance program premiums have been properly assessed and recorded;	_____	_____	_____
	d. Claims payable for self-insurance programs have been properly determined and recorded;	_____	_____	_____
	e. Claims payable for self-insurance programs conform to self-insurance requirements; and,	_____	_____	_____
	f. Note disclosures relative to the local government's insurance programs provide adequate disclosure; Except as follows: ________ ________ ________	_____	_____	_____

This audit program section has been completed in accordance with firm policy.

	Date
Done by ______________________	________
Reviewed by ______________________	________

The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

Obj.		Done By	Date	W/P Ref.

.100 X. Pension Trust Funds

Financial Statement Assertions

1. Existence or occurrence
2. Completeness
3. Rights and obligations
4. Valuation or allocation
5. Presentation and disclosure

Audit Objectives

A. The physical evidences of ownership of investments reported in the financial statements (stock certificates, bonds, notes, etc.) are on hand or held in custody or safekeeping by others for account of the client's pension trust funds. (Assertions 1, 2, and 3)

B. Adequate disclosure has been made of the pledging of any investments, and credit risks are properly disclosed as required by GASB Statement No. 3. (Assertions 3 and 5)

C. Investments and the related income are properly valued, allocated, classified, and described in the financial statements. (Assertions 2, 4, and 5)

D. Insurance contracts and accounts established to fund employee benefits are appropriately reported in the financial statements. (Assertions 4 and 5)

E. The amounts received or due the plan have been determined in accordance with plan requirements and recorded and reported in conformity with generally accepted accounting principles, including the establishment of an appropriate valuation allowance. (Assertions 3, 4, and 5)

F. Benefit payment amounts conform to plan provisions. (Assertion 3)

G. Financial statement representations are consistent with actuarial findings. (Assertions 4 and 5)

H. Applicable accounting principles have been consistently applied. (Assertions 4 and 5)

I. Required supplementary information has been presented in accordance with guidelines established for its presentation and measurement. (Assertions 2 and 5)

Note: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

A. Audit Planning

1. Discuss the following with pension plan administrators, trustees, or other appropriate client officials:
   a. Covered employees, retirees, etc. ______ ______ ______

Obj.		Done By	Date	W/P Ref.
	b. Participating employers.			
	c. Types of plans (defined benefit or defined contribution plan).			
	d. Date of latest actuarial review or update, name and address of actuary, and GASB Statement No. 5 actuarial requirements.			
	e. Names and titles of client contact personnel and their respective responsibilities for the plan or plans.			
	f. Funding of plan (self-insured, insured, or split-funded).			
	g. Custody of investments.			
	h. Responsibility for plan administration and location of accounting records and participant's data.			
	i. The extent that records are automated and whether the local government or an outside EDP service processes plan data.			
	j. Citations of applicable statutes and rules.			
	k. The nature and extent of special reporting requirements, if any, and related audit requirements.			
	l. The extent of involvement, if any, of specialists, consultants, internal auditors, and other independent auditors.			
	m. Basis upon which financial statements are prepared (whether NCGA Statement 1, NCGA Statement 6, FASB Statement No. 34, or other).			
	n. Significant changes in accounting principles, plan provisions, actuarial methods, etc.			
	o. Significant contracts, litigation, or contingencies.			
	p. If assets are held by a trustee, the nature of the trustee arrangement ("directed trust" or "discretionary trust").			
	q. The extent to which component unit pension plans exist.			
	2. Read the pension plan instruments, including amendments, to determine how the plan works, its funding, participating employers and employees, basis for determining benefits, etc.			
	3. Read state and local statutes and rules authorizing the retirement programs and note all pertinent laws of potential material impact (for example, provisions specifying legal investment types).			
	4. Read agreements with trustees, investment advisers, and insurance companies.			
	5. Obtain and review relevant policy and procedure manuals and flowcharts.			
	6. Read the prior year's annual report and current and prior year filings with regulatory agencies.			
	7. Obtain from other independent auditors special purpose reports on the internal accounting control structure of service organizations which were responsible for executing, recording, and/or processing financial or finance-related data (for example, trustees with significant responsibility for pension plans or investment administration).			
	8. Read reports from actuaries, trustees, insurance companies, other independent auditors, and internal auditors.			
	9. Coordinate audit progress with trustees, actuaries, services centers, employers, other independent auditors, internal auditors, and others, as necessary.			
	10. Consider integration of pension trust fund audit procedures with those specified for other segments (for example, use of payroll sample item to test participant records).			

Obj.		Done By	Date	W/P Ref.
	B. Evaluation of Internal Control Structure			
	1. Review the documentation and conclusions resulting from the steps taken to understand and test the internal control structure policies, procedures, and records relevant to planning the audit of the pension trust fund and related areas.	____	____	____
	2. Consider the understanding obtained of the internal control structure, the assessed level of control risk (together with assessment of inherent risk), and the acceptable level of detection risk to determine the nature, timing, and extent of substantive tests.	____	____	____
	3. Revise the audit program, as appropriate, following the consideration of the internal control structure and related audit risks.	____	____	____
	C. Analytical Procedures			
	1. Review the planning procedures applicable to analytical procedures performed on the pension trust funds and related areas and consider the result of the procedures in determining the nature, timing, and extent of other audit procedures.	____	____	____
	2. Revise the audit program, as appropriate, following consideration of the results of the analytical procedures.	____	____	____
	3. If analytical procedures are used for substantive testing purposes, document the basis for the expected relationship, the results of the comparison of the recorded amount to the expectation, and the results of the evaluation of unexpected differences between the recorded amount and the expectation.	____	____	____
	D. Other Auditing Procedures—Investments			
[A] [B] C	1. Obtain an analysis of changes in investments during the period.	____	____	____
A	2. Obtain evidence (by confirmation or physical count) concerning the existence and ownership of the investments.	____	____	____
B	3. Obtain information concerning any liens, pledges, or other security interests by reviewing minutes, agreements, and confirmations.	____	____	____
A B	4. For assets held by a trustee, obtain and review information concerning the trustee's responsibility and financial capability.	____	____	____
C	5. Reconcile amounts confirmed or counted to recorded accountability.	____	____	____
[A] [B] C H	6. Test investment transactions for proper authorization, legality, proper recording as to dates, amounts, quantities, descriptions, and computation and allocation of gains and losses.	____	____	____
C H	7. Determine that income accruing from investments has been properly allocated and recorded.	____	____	____
C H	8. Obtain market values at balance sheet date and investigate significant differences from recorded values to determine if any write-downs are necessary.	____	____	____
B	9. Review GASB Statement No. 3 disclosures.	____	____	____
A C	10. Perform such procedures as necessary to satisfy audit objectives concerning plan investments administered by trustees. (Note: It may be necessary to perform auditing procedures at the trustee's offices.) The extent of the trustee's responsibility for investment decisions, the physical location of available records, and the extent to which relevant reports of other independent auditors are available.	____	____	____
D	11. For plan assets held by an insurance company:			
	a. Read the contracts between the contract holder and the insurance company.	____	____	____
	b. Confirm with the insurance company:			
	(1) Contributions or premium payments.	____	____	____
	(2) Interest, dividends, refunds, credits, and changes in value and whether such amounts have been charged or credited during the year on an estimated or actual basis.	____	____	____

Obj.		Done By	Date	W/P Ref.
	(3) The contract value or the fair value of the funds at the plan's year-end and the basis for determining such values.			
	(4) The amount of insurance company fees and other expenses.			
	(5) Annuity purchases or benefits paid.			
	(6) Transfers between funds or accounts.			
	c. Reconcile the confirmed balances and transactions with amounts recorded and reported by the client.			
	d. Where it appears that records must be evaluated at the insurance company to satisfy audit objectives, consider requesting special purpose reports from the insurance company's independent auditors or internal auditors.			
	e. Evaluate compliance with contract terms.			
	f. Evaluate reasonableness of amounts credited to the contracts.			
	g. Evaluate the sufficiency of related note disclosures.			
	E. Other Auditing Procedures—Contributions and Related Receivables			
E	1. Obtain a list of participating employers (for multi-employer plans) and test its completeness by comparing the list to appropriate plan documents, statutory requirements, etc.			
E	2. Obtain a schedule showing contributions received or receivable sorted by employer and compare to the list of participating employers.			
E H	3. Test contribution reports for arithmetic accuracy, use of the proper contribution rates, the use of the proper payroll or salary base amount, and proper posting to cash receipt records and bank statements or trustee reports.			
E H	4. Test posting from the employer contribution reports to participant records and from participant records to contribution reports.			
E H	5. Reconcile contributions received to the plan's cash receipt records and bank statements or trustee records.			
E H	6. Confirm directly with contributors amounts contributed and receivable.			
E H	7. Review accruals for conformance with generally accepted accounting principles.			
E H	8. Evaluate the reasonableness of the plan's allowance for doubtful accounts.			
E	9. Compare contribution rates used to those recommended by the plan's actuary and those required by statute or rule.			
E	10. Consider the results of the auditing procedures applied to participant data and their effect, if any, on the amounts recorded as contributions and contributions receivable.			
E	11. Review note disclosures relative to pension plan contributions and related receivables.			
	F. Other Auditing Procedures—Benefit Payments and Payables			
F H	1. For selected participants or beneficiaries receiving benefit payments:			
	a. Evaluate file documentation supporting eligibility and authorizing payments.			
	b. Recompute benefit payment amounts and compare to actual payments.			
	c. Examine cancelled check as to amount, date, signatures, and endorsements.			
	d. Verify proper posting to cash disbursement, participant, and general ledger records.			

Obj.	Procedure	Done By	Date	W/P Ref.
F	2. For a sample of cancelled benefit payment checks, compare payee, amount, date, signatures, and endorsements to related file documentation authorizing the payment and verify proper posting to cash disbursement, participant, and general ledger records.			
F	3. Evaluate the continued eligibility of participants or beneficiaries to whom payments have been made over an unusually long period of time.			
F	4. Investigate benefit payment checks which have been outstanding for a long period of time.			
F	5. Confirm benefit payments with selected participants or beneficiaries and compare confirmation signatures with related file documentation.			
F H	6. Evaluate benefit payment accruals for conformance with generally accepted accounting principles.			
	G. Other Auditing Procedures—Participants' Data and Plan Objectives			
E F	1. By reviewing pertinent sections of the pension plan instrument, statutes, or rules, identify participant data which should be tested because of its use in determining vesting, eligibility or benefit amounts (for example, demographic data, payroll data, benefit levels and options, etc.).			
E	2. For selected participants, verify relevant participant file data by comparing it to corroborative employer records (such as payrolls, employee earnings records, personnel files, etc.).			
E F	3. For selected employees, trace payroll data to participant file data.			
E F	4. Confirm participant file data with participants.			
E	5. Review tests, if any, by the plan administrator of data submitted by employees (for multi-employer plans).			
E	6. Consider obtaining a special report from employer auditors concerning the application of procedures similar to those described above.			
G	7. With regard to actuarial valuations of defined benefit plans:			
	a. Obtain information concerning the professional qualifications and reputation of the actuarial firm.			
	b. Obtain an understanding of the actuary's methods and assumptions.			
	c. Submit an inquiry to the actuary concerning:			
	(1) Whether the actuarial valuation considers all pertinent provisions of the plan, including any changes to the plan or other events affecting the actuarial calculations.			
	(2) Relationships between the actuary and the plan or an employer which may impair the actuary's objectivity.			
	(3) Aggregate and selected individual participant data amounts used in the actuarial valuations.			
	(4) Whether the actuary has reviewed the relevant portions of the financial statements and agrees with such information as presented.			
	d. Verify the accuracy and completeness of the participant data used in the actuarial valuations.			
E F	8. With respect to defined contribution plans:			
	a. Verify that allocations of income or loss, investment appreciation or depreciation, administrative expenses, and forfeitures have been made in accordance with plan provisions.			
	b. Employer contributions have been properly allocated.			

Obj.		Done By	Date	W/P Ref.
	c. Employee contributions have been credited to the proper participant account and investment medium.			
	d. Verify that the sum of individual accounts reconciles with total net assets available for benefits.			
I	**H. Review Procedures—Required Supplementary Information**			
	1. With regard to 10-year historical trend information, inquire of management as to the methods used in preparing the information including:			
	a. Whether it is measured and presented in accordance with the guidelines of GASB.			
	b. Whether the methods of measurement or presentation have been changed from those of the prior period and the reasons for such changes.			
	c. Any significant assumptions or interpretations underlying the measurement or presentation.			
	2. Compare the information for consistency with:			
	a. Management's responses to the above inquiries.			
	b. Audited financial statements.			
	c. Other knowledge obtained during the examination of the financial statements.			
	3. Consider whether representations on required supplementary information should be included in the request for the management representation letter.			
	4. Make additional inquiries if application of the above procedures indicates that the 10-year historical trend information may not be measured or presented in accordance with GASB guidelines.			
	I. Overall Conclusions			
	1. In our opinion, we have obtained sufficient and competent evidential matter to provide reasonable assurance that:			
	a. The physical evidences of ownership of investments reported in the financial statements (stock certificates, bonds, notes, etc.) are on hand or held in custody or safekeeping by others for account of the client's pension trust funds;			
	b. Investments and the related income are properly valued, allocated, classified and described in the financial statements;			
	c. Adequate disclosure has been made of the pledging of any investments and credit risks are properly disclosed as required by GASB Statement No. 3;			
	d. Insurance contracts and accounts established to fund employee benefits are appropriately reported in the financial statements;			
	e. The amounts received or due the plan have been determined in accordance with plan requirements and recorded and reported in conformity with generally accepted accounting principles, including the establishment of an appropriate valuation allowance;			
	f. Benefit payment amounts conform to plan provisions;			
	g. Financial statement representations are consistent with actuarial findings;			
	h. Applicable accounting principles have been consistently applied; and,			

Obj.		Done By	Date	W/P Ref.
	i. Required supplementary information has been presented in accordance with guidelines established for its presentation and measurement; Except as follows: ______ ______ ______	______	______	______

This audit program section has been completed in accordance with firm policy.

	Date
Done by ______	______
Reviewed by ______	______

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Obj.		Done By	Date	W/P Ref.

.110 XI. Financial Reporting

Financial Statement Assertions

1. Existence or occurrence
2. Completeness
3. Rights and obligations
4. Valuation or allocation
5. Presentation and disclosure

Audit Objectives

A. The financial statements being reported upon are fairly stated in accordance with generally accepted accounting principles consistently applied, including all required disclosures, or in accordance with another comprehensive basis of accounting. (Assertions 1, 2, 3, 4, and 5)

B. Our report on the examination is appropriately worded, and in conformity with generally accepted auditing standards.

Note: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

A. Evaluation of Internal Control Structure

1. Review the documentation and conclusions resulting from the steps taken to understand and test the internal control structure policies, procedures, and records relevant to planning the audit of financial reporting. ____ ____ ____
2. Consider the understanding obtained of the internal control structure, the assessed level of control risk (together with assessment of inherent risk), and the acceptable level of detection risk to determine the nature, timing, and extent of substantive tests. ____ ____ ____
3. Revise the audit program, as appropriate, following the consideration of the internal control structure and related audit risks. ____ ____ ____

B. Analytical Procedures

1. Review the planning procedures applicable to analytical procedures performed on the financial statements and consider the result of the procedures in determining the nature, timing, and extent of other audit procedures. ____ ____ ____
2. Revise the audit program, as appropriate, following consideration of the results of the analytical procedures. ____ ____ ____

Obj.		Done By	Date	W/P Ref.
	3. If analytical procedures are used for substantive testing purposes, document the basis for the expected relationship, the results of the comparison of the recorded amount to the expectation, and the results of the evaluation of unexpected differences between the recorded amount and the expectation.			
	C. Other Auditing Procedures			
A	1. Obtain, or prepare a trial balance of general ledger accounts for the working papers, trace balances to general ledger and foot the trial balance.			
A	2. Review client's year-end adjusting journal entries for unusual items.			
A	3. Post all adjusting and reclassification journal entries that have properly been approved by firm and client personnel to the working papers, and give a copy of appropriate entries to the client for posting to the books.			
A	4. Prepare a summary of past adjustments which reflects the net effect of such adjustments on individual fund assets, liabilities, equity, revenue, and expenditures. Determine if the overall effect on each fund type is material and state conclusion in summary. Consider the need for additional audit adjustments.			
A	5. Extend trial balances and compare to amounts reported in the financial statements.			
A	6. Obtain confirmation letters from the client's attorneys.			
	a. Ascertain that replies received are complete and that all contingencies mentioned are considered for possible disclosure in the financial statements.			
	b. Obtain opinion as to compliance of the budget adoption and approval process.			
A	7. Obtain signed minutes representation letter and ascertain that we have received and reviewed all minutes listed in the letter.			
A	8. Obtain signed management representation letter. Include appropriate reference to budget adoption.			
A	9. Examine the appropriate statements of economic interests for purposes of review regarding any possible conflicts of interest.			
A	10. Examine and schedule surety bonds. Determine legal requirements with regard to adequacy of coverage.			
A	11. Ascertain that all required disclosures are included in the financial statements or notes. See AICPA *Disclosure Checklists for State and Local Governmental Units.*			
B	12. Ascertain that the independent auditors' report is appropriately worded.			
A	13. Have the client review and approve the final draft of the financial statements.			
	14. Make appropriate notations regarding matters to be discussed with audit partner, manager, or in-charge auditor.			
	D. Overall Conclusions			
	1. In our opinion, we have obtained sufficient and competent evidential matter to provide reasonable assurance that:			
	a. The financial statements being reported upon are fairly stated in accordance with generally accepted accounting principles consistently applied, including all required disclosures, or in accordance with another comprehensive basis of accounting; and,			

Obj.		Done By	Date	W/P Ref.
	b. Our report on the examination is appropriately worded and in conformity with generally accepted auditing standards. Except as follows: ______ ______ ______	____	____	____

This audit program section has been completed in accordance with firm policy.

	Date
Done by ______	______
Reviewed by ______	______

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Obj.		Done By	Date	W/P Ref.
	.120 XII. Budget Compliance			
	A. Audit Procedures to Test Budgetary Compliance			
	1. Examine evidence of monitoring process for budgetary controls.	____	____	____
	2. Review evidence of corrective action taken on significant variations from budget noted from the monitoring process.	____	____	____
	3. Review documentation of interim changes to budgeted reviews.	____	____	____
	4. Compare prior year's actual expenditures and revenues to current budget.	____	____	____
	5. Compare interim budget reports with actual results for evidence of noncompliance.	____	____	____
	6. For any material excess of expenditures over appropriations in individual funds:			
	a. Determine whether such excess constitutes a violation of law.	____	____	____
	b. Determine whether such excess has adequately been disclosed.	____	____	____
	7. Review reconciliation of budgetary and GAAP bases.	____	____	____

This audit program section has been completed in accordance with firm policy.

	Date
Done by ________________	________
Reviewed by ________________	________

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Obj.		Done By	Date	W/P Ref.

.130 XIII. Subsequent Events

Financial Statement Assertions

1. Existence or occurrence
2. Completeness
3. Rights and obligations
4. Valuation or allocation
5. Presentation and disclosure

Audit Objectives

A. There are no significant unrecorded liabilities as of the date of the balance sheet. (Assertions 2, 3, and 5)

B. The effect of any significant or unusual transactions occurring during the period from the balance sheet date to the date of our report is adequately considered or disclosed in the financial statements. (Assertions 1, 2, 4, and 5)

Note: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

A. Review Procedures

1. For period following balance sheet date, perform the following procedures in the areas summarized below. This audit program is not to be considered an all-inclusive summary of procedures to be performed but only a guide; the industry, accounting procedures, and internal control structure of the local government should be considered in determining the nature and extent of the review.
2. Attach a memorandum setting forth other records reviewed, steps performed, and your conclusions regarding the above subsequent events review. ____ ____ ____

B. Scope of Review

From: ____________ (Audit Date)

To: ____________ (Report Date—Last Date of Significant Field Work)

Obj.		Done By	Date	W/P Ref.
A	1. For vouchers recorded in subsequent period, account for all serial numbers for subsequent period (No. ____ to No. ____) and examine vouchers over $____ for unrecorded liabilities.	____	____	____
A	2. For vendors' invoices in process of being recorded at date of report, scan invoices and examine invoices over $____________ for unrecorded liabilities.	____	____	____
A B	3. Check register:			
	a. Account for all checks issued in subsequent period (No. ____ to No. ____).	____	____	____
	b. Scan check register or numerical checkfile in subsequent period for amounts over $____________ not supported by voucher.	____	____	____
	c. Examine support for items over $____________ noted in 3b for unrecorded liabilities.	____	____	____
B	4. Review interim financial statements for period subsequent to balance sheet date and relate them to statements being reported on as well as to statements for comparable prior periods. Investigate any significant differences, results, events, or changes in accounting method.	____	____	____
B	5. Review all journal entries and scan general ledger for subsequent period for any large ($____________) or unusual entries and obtain explanation of entries noted.	____	____	____
B	6. Review cash receipts summaries and review cash receipts data not entered in cash receipts summary for the subsequent period for large ($____________) or unusual items and obtain explanation.	____	____	____
A B	7. Review minutes of governing body and important committee meetings. (Note: Where minutes have not been prepared in final form, obtain draft copies or inquire as to what transpired in the meetings.)	____	____	____
A B	8. Inquire of responsible officials as to the following items (attach memorandum or comments regarding significant matter discussed):			
	a. Receivables:			
	(1) Exceptional bad debt losses.	____	____	____
	b. Property and equipment:			
	(1) Purchase or sale of major plant/equipment.	____	____	____
	(2) Commitments or plans for major purchases or sales of plant/equipment.	____	____	____
	(3) Loss of plant/equipment due to fires, abandonment, etc.	____	____	____
	c. Liabilities:			
	(1) New borrowings, including important covenants agreed to in connection therewith.	____	____	____
	(2) Liabilities in dispute or being contested, such as creditors' invoices.	____	____	____
	d. Litigation:			
	(1) Pending lawsuits and/or settlements of lawsuits.	____	____	____
	(2) Wage negotiations or strikes in progress or pending.	____	____	____
	(3) Penalties assessed (such as environmental type penalties)	____	____	____
	(4) Loss of significant grant funds or notices of potential disallowances.	____	____	____
	e. Other matters:			
	(1) Changes in accounting and/or financial policies.	____	____	____
	(2) Illegal acts.	____	____	____

Obj.		Done By	Date	W/P Ref.
	(3) Others (list as applicable): ______ ______ ______ ______ ______	___	___	___
	9. Make appropriate notations regarding matters to be discussed with audit partner, manager, and/or in-charge auditor.	___	___	___
	C. Overall Conclusions			
	1. In our opinion, we have obtained sufficient and competent evidential matter to provide reasonable assurance that:			
	a. There are no significant unrecorded liabilities as of the date of the balance sheet; and,	___	___	___
	b. The effect of any significant and/or unusual transactions occurring during the period from the balance sheet date to the date of our report is adequately considered and/or disclosed in the financial statements; Except as follows: ______ ______ ______	___	___	___

This audit program section has been completed in accordance with firm policy.

	Date
Done by ______	______
Reviewed by ______	______

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Obj.		Done By	Date	W/P Ref.

.140 XIV. Federal Financial Assistance (Single Audit)

Financial Statement Assertions

1. Existence or occurrence
2. Completeness
3. Rights and obligations
4. Valuation or allocation
5. Presentation and disclosure

Audit Objectives

A. The financial statements of the entity are presented in conformity with GAAP. (Assertions 1, 2, 3, 4, and 5)

B. The local government's internal control structure provides reasonable assurance that it is managing federal and state financial assistance programs in compliance with applicable laws and regulations. (Assertions 1 and 2)

C. The local government has complied with laws and regulations that have a material effect on the financial statements and on each major federal financial assistance program. (Assertions 1, 2, and 3)

Note: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

A. Audit Planning

Obj.	Procedure	Done By	Date	W/P Ref.
C	1. Review applicable laws, regulations, and other references governing performance of the single audit of federal financial assistance (see AAM section 5610).	____	____	____
B	2. Obtain a copy of the local government's single audit report from the preceding year. Make note of federal programs, reportable conditions relating to the internal control structure, and any compliance findings. Obtain copy of client's corrective action plan. Determine if any state programs are to be included in the audit scope.	____	____	____
B [C]	3. Review and discuss with responsible local government officials the procedures used to administer federal programs.	____	____	____
A C	4. Obtain a schedule of federal financial assistance, reconcile the schedule to the general accounting records, and:			
	a. Determine that the schedule includes all types of federal assistance as defined by OMB Circular A-128, paragraph 5b.	____	____	____

Obj.		Done By	Date	W/P Ref.
	b. Determine that the schedule reports federal "programs," not individual grants. Federal programs are defined in the *Catalog of Federal Domestic Assistance.*	____	____	____
	c. Determine the "entity" for Single Audit purposes.	____	____	____
	d. Where appropriate, contact the cognizant agency and receive input on important areas.	____	____	____
	e. Determine that the schedule shows at a minimum:			
	(1) The program title and the CFDA number for each program, unless the program is not included in the *Catalog of Federal Domestic Assistance.* Those programs not included in the *Catalog* should be shown as other federal assistance;	____	____	____
	(2) Total expenditures for each federal program by grantor, department, or agency; and,	____	____	____
	(3) Total federal financial assistance expenditures.	____	____	____
	5. Rank the federal programs in descending order by expenditure amount, determine the major program threshold, and identify the major federal financial assistance programs.	____	____	____
B	6. For testing internal controls, if expenditures for all major programs do not exceed 50 percent of total federal financial assistance program expenditures, or if the local government has no major federal financial assistance programs, select the largest nonmajor programs until at least 50 percent of total federal financial assistance expenditures are included.	____	____	____
B	7. Review samples selected during tests of the internal control structure and the examination of the general purpose financial statements and identify nonmajor program transactions included therein.	____	____	____
A B C	8. Prepare a working paper showing the federal programs to be subjected to further auditing procedures and indicate the nature of the procedures to be applied to each program. Such procedures may include:			
	a. Obtain an understanding of the internal control structure policies and procedures relevant to the programs administered (required for all federal programs: however, see PCIE Position Statement No. 3 that provides for the rotation of nonmajor programs on a 3-year basis for purposes of obtaining an understanding of the internal control structure).	____	____	____
	b. Internal control structure evaluation (required for all major programs and nonmajor programs selected pursuant to the "50 percent rule").	____	____	____
	c. Program compliance review (required for all major programs to determine compliance with laws and regulations material in effect to the respective program).	____	____	____
	d. Transaction compliance review (required for nonmajor program transaction selected for testing as a result of the audit of the general purpose financial statements).	____	____	____
C	9. Obtain a copy of grant agreements for those programs selected for testing from the permanent file. Review the documents for unusual provisions, budgets, or other items of significance. Also, locate other sources of compliance information, for example the OMB *Compliance Supplement for Single Audits of State and Local Governments,* specific program regulations, the *Catalog of Federal Domestic Assistance, etc.*	____	____	____

Obj.		Done By	Date	W/P Ref.
B [C]	10. While testing internal controls, obtain an understanding of the possible effects on each major program (and the largest nonmajor programs if the 50 percent rule must be applied) of applicable program laws, rules, and regulations. Document this understanding by listing those laws, rules, and regulations which may have a material effect on the allowability of program expenditures in the event of substantial noncompliance. These laws, rules, and regulations shall be considered during the evaluations of administrative controls, tests of transactions, and other procedures deemed necessary (e.g., tests of compliance with matching requirements).			
[A] C	11. Determine if the local government has an indirect cost allocation plan.			
[A] C	12. Determine the extent to which grantor funds have been disbursed to subrecipients.			
	13. Discuss with client the format desired for the Single Audit Report (included in the CAFR, separate Single Audit Report, etc.).			
	B. Internal Control Structure Evaluation			
B	1. Identify the significant categories of internal controls.			
B	2. For major and nonmajor programs, obtain an understanding of the internal control structure policies and procedures relevant to the programs administered. (Note: PCIE Statement Nos. 2 and 3 permit obtaining an understanding of the internal control structure for nonmajor programs on a 3-year cycle.)			
B	3. For major programs (and selected nonmajor programs selected pursuant to the "50% rule"), perform tests of controls to evaluate the effectiveness of the design and operation of the internal control structure policies and procedures relevant to preventing or detecting material noncompliance with:			
	a. *Specific Requirements:* For examples of common control procedures which should be evaluated as part of a basis for issuing an opinion on compliance with laws and regulations applicable to federal financial assistance programs, see AAM section 4600.			
	(1) Types of services allowed or not allowed;			
	(2) Eligibility;			
	(3) Matching, level of effort, or earmarking;			
	(4) Reporting;			
	(5) Special tests and provisions.			
	b. *General Requirements:* For examples of common control procedures which should be evaluated as part of a basis for issuing an opinion on compliance with laws and regulations applicable to federal financial assistance programs, see AAM section 4600.			
	(1) Civil rights;			
	(2) Political activity;			
	(3) Cash management;			
	(4) Davis-Bacon Act;			
	(5) Relocation assistance and real property management;			
	(6) Federal financial reports;			
	(7) Allowable costs/cost principles;			
	(8) Drug-Free Workplace Act;			
	(9) Administrative requirements.			
	c. Revise audit program as appropriate.			
	C. Compliance Procedures			

Obj.		Done By	Date	W/P Ref.
A	1. For selected grants determine that grant receipts were properly recorded and classified, in compliance with grant conditions.	____	____	____
	a. Review receipts issued shortly before and shortly after year-end to determine that all cash collected has been recorded in the proper period.	____	____	____
A [C]	2. For each major federal and state program, select a sample of expenditures charged and determine whether:			
	a. Expenditures appeared reasonable and necessary for the program;	____	____	____
	b. Expenditures were for allowable charges under the terms of the program and were adequately documented;	____	____	____
	c. Expenditures were properly authorized and recorded as to program, account, amount, and period;	____	____	____
	d. Records document that those who received services or benefits were eligible to receive them;	____	____	____
	e. Expenditures were in accordance with the provisions of OMB *Compliance Supplement for Single Audits of State and Local Governments* applicable to the particular transaction;	____	____	____
	f. Expenditures were in accordance with the provisions of OMB Circular A-87 applicable to the particular transaction;	____	____	____
	g. Expenditures were in accordance with the provisions of OMB Circular A-102 and the "Common Rule" to the extent applicable to the grantor and the particular transaction; and,	____	____	____
	h. Expenditures were in accordance with applicable state laws and program requirements.	____	____	____
	3. For each major federal and state program and selected nonmajor federal programs, as applicable, perform general (see supplemental audit program on general requirements) and specific compliance tests. List programs and attach separate work programs based on the *Compliance Supplement for Single Audits of State and Local Governments* or other sources (grants agreements, etc.):			
	a. ____________________	____	____	____
	b. ____________________	____	____	____
	c. ____________________	____	____	____
	d. ____________________	____	____	____
	4. Determine that nonmajor program transactions tested as part of an audit of the general purpose financial statements comply with the laws and regulations applicable to each of the respective transactions. This includes the following:			
	a. Expenditures appeared reasonable and necessary for the program;	____	____	____
	b. Expenditures were for allowable charges under the terms of the program and were adequately documented;	____	____	____
	c. Expenditures were properly authorized and recorded as to account, amount, and period.	____	____	____
	d. Records document that those who received services or benefits were eligible to receive them; and,	____	____	____
	e. Amounts were determined according to Circular A-87 and Circular A-102.	____	____	____
	D. Test of Subrecipient Compliance			
	If the local government does not pass through federal monies to subrecipients (receiving at least $25,000) of federal programs, check here ____ and omit the balance of this section.			
	1. Determine all subrecipients receiving at least $25,000.	____	____	____

Obj.		Done By	Date	W/P Ref.
	2. Review the local government's controls established to monitor that the subrecipient spent the federal funds in compliance with applicable laws and regulations. (OMB Circulars A-87, A-102, and A-128)	____	____	____
	3. Determine that the local government monitored the subrecipient audit reports (the subrecipient must meet the audit requirements of A-110 or A-128) and has taken any corrective measures required.	____	____	____
	E. Property			
A	1. For selected property items acquired with grant funds, review the property records to determine that the records include a description of the property, a serial number or other identification number, the source of the property, who holds title, acquisition date, cost, location, use and condition of the property, percentage of federal participation, and disposition data.	____	____	____
	2. Determine that title to the property has been properly recorded in the government's name.	____	____	____
	3. Determine that a physical inventory of property is taken and reconciled to the property records at least once every two years.	____	____	____
	4. For property dispositions, review supporting documentation to ascertain the conditions of disposition and determine that any required settlements have been made with the awarding agency.	____	____	____
	F. Reporting on Federal and State Financial Assistance			
	1. Determine that the signed management representation letter(s) contained references regarding Single Audit representations.	____	____	____
	2. If the local government requests that the Report on Federal and State Financial Assistance be included with their annual financial statements, prepare the Independent Auditor's Report on such financial statements and determine that it is appropriately worded and dated.	____	____	____
	3. If the client requests a separate Report on Federal and State (if applicable) Financial Assistance, prepare the Independent Auditor's Report on the schedule of Federal and State financial assistance.	____	____	____
	4. Prepare the schedule of findings and questioned costs. (See AAM section 5600.180.)	____	____	____
	5. Prepare the Independent Auditor's Report on the internal control structure based on an evaluation made as part of the audit of the general purpose financial statements.	____	____	____
	6. Prepare the Independent Auditor's Report on Internal Control Structure Used in Administering Federal Financial Assistance Programs required by the Single Audit Act.	____	____	____
	7. Prepare the Independent Auditor's Report on compliance with laws and regulations that may have a material effect on the general purpose financial statements.	____	____	____
	8. Prepare the Independent Auditor's Reports on compliance required by the Single Audit Act.	____	____	____
	9. Review the Single Audit Report draft with appropriate local government officials.	____	____	____
	G. Overall Conclusion			
	1. In our opinion, we have obtained sufficient and competent evidential matter to provide reasonable assurance that:			
	a. The local government has complied with laws and regulations that may have a material effect upon the financial statements;	____	____	____
	b. The local government's internal control structure provides reasonable assurance that the local government is managing its federal programs according to the applicable laws and regulations;	____	____	____

Obj.		Done By	Date	W/P Ref.
	c. The local government has complied with laws and regulations that may have a material effect upon each major federal program, according to generally accepted auditing standards, the provisions of *Government Auditing Standards,* promulgated by the U.S. General Accounting Office, as they pertain to financial audits, the Single Audit Act of 1984 (Pub. Law No. 95-502) the provisions of the Office of Management and Budget's Circular No. A-128, *Audits of State and Local Governments,* and the *Compliance Supplement for Single Audits of State and Local Governments.* Except as follows: __________ __________ __________	____	____	____

This audit program section has been completed in accordance with firm policy.

	Date
Done by	
Reviewed by	

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Obj.		Done By	Date	W/P Ref.

.150 XV. Financial Assistance Supplement

A. Test of General Compliance Requirements

1. Political Activity

Compliance Requirement—Federal funds cannot be used for partisan political activity of any kind by any person or organization involved in the administration of federally-assisted programs. (Hatch Act (5 U.S.C. 1501-1508) and Intergovernmental Personnel Act of 1970 as amended by Title VI of Civil Service Reform Act (Public Law 95-454), Section 4728).

Auditing Procedures

a. Test the expenditures and related records for indications of lobbying activities, publications, or other materials intended for influencing legislation or similar type costs. _____ _____ _____

b. Test the personnel and payroll records, and identify persons whose responsibilities or activities include political activity. _____ _____ _____

c. Test whether the above costs, if any exist, are charged directly or indirectly, to federally-assisted programs. _____ _____ _____

2. Davis-Bacon Act

Compliance Requirement—When required by the federal grant program legislation, all laborers and mechanics employed by contractors or subcontractors to work on construction projects financed by federal assistance must be paid wages not less than those established for the locality of the project by the Secretary of Labor. (40 Stat 1494, Mar. 3, 1921, Chap. 411, 40 U.S.C.276A-276A-5)

Auditing Procedures

a. Identify the programs involving construction activities. _____ _____ _____

b. Review selected construction contracts and subcontracts and determine whether they contain provisions requiring the payment of "prevailing" wages. _____ _____ _____

c. Review the Government's system for monitoring applicable contractors and subcontractors with respect to payment of prevailing wages and evaluate for adequacy. _____ _____ _____

d. Review the monitoring system for contracts for selected programs and determine whether there is adherence to prescribed procedures. _____ _____ _____

e. For Governments that have not developed a system, or for a system not operating effectively:

(1) Obtain the "local" DOL wage determination from the recipient, the architect/engineer (A/E) managing the project, or DOL. _____ _____ _____

Obj.		Done By	Date	W/P Ref.

(2) Obtain from the auditee payroll registers of the construction company and test to determine whether wages paid conform to the prevailing wages. ____ ____ ____

3. **Civil Rights**

Compliance Requirement—No person shall, on the grounds of race, color, national origin, age, or handicap, be excluded from participation in or be subjected to discrimination in any program or activity funded, in whole or in part, by federal funds. Discrimination on the basis of sex or religion is also prohibited in some federal programs. (Age—42 U.S.C. 6101 et seq.; Race—42 U.S.C. 2000d; Handicap—29 U.S.C. 794.)

Auditing Procedures

a. Determine whether the governmental unit has announced a formal policy of nondiscrimination. ____ ____ ____

b. For recipients employing 15 or more persons, ascertain whether a person has been designated to oversee civil rights compliance. ____ ____ ____

c. Ascertain from the grant agreement(s) whether any of the programs contain prohibitions against discrimination on the basis of sex or religion. ____ ____ ____

d. Ascertain the number of complaints filed with federal, state and/or local agencies responsible for ensuring nondiscrimination in government programs during the fiscal year, the status of unresolved complaints or investigations, and the actions taken on resolved complaints or completed investigations. ____ ____ ____

e. Ascertain whether programs contain prohibitions against discrimination in employment; for those programs (1) review the annual report filed with the Equal Employment Opportunity Commission (EEOC), if any, (2) ascertain the number of complaints or completed investigations and (3) review the status of and actions taken on unresolved complaints or investigations. ____ ____ ____

f. Determine whether facilities financed by federal funds that are required to be located in a nondiscriminatory manner are so located. ____ ____ ____

g. Obtain representation and/or attorney letters to determine if any civil rights suits have been adjudicated or are pending. ____ ____ ____

4. **Cash Management**

Compliance Requirement—Grantee financial management systems shall include procedures to minimize the time elapsed between the transfer of funds from the U.S. Treasury and disbursement of funds by the Grantee.

Advances made by primary recipients to secondary recipients shall conform substantially to the same standards of timing and amount as apply to advances by federal agencies to primary recipient organizations.

(OMB Circular A-102; Intergovernmental Cooperation Act of 1968, P.L. 90-577 (sec. 403), as amended by P.L. 96-470, Title I, Section 10-1(b)).

Auditing Procedures

a. Review the Government's cash forcasting process and evaluate for adequacy.[1] ____ ____ ____

b. Review the Government's system for requesting federal funds and evaluate whether it is adequate to keep federal cash disbursements limited to the Government's immediate needs. ____ ____ ____

[1] For purposes of the Compliance Supplement, adequacy can be interpreted as providing a reasonable assurance that the system or procedures, if followed, will result in the intended event or action occurring.

Obj.		Done By	Date	W/P Ref.

c. For selected grant programs, determine dates and amounts for selected advances, drawdowns, and other receipts of federal funds and compare to the dates the funds were disbursed or checks were presented to the banks for payment. ____ ____ ____

d. For the same programs, evaluate the size of the balances in relation to the program's needs. ____ ____ ____

e. Review the Government's system for monitoring advances and payment requests by secondary recipients. Evaluate whether the system is sufficient to limit payments to amounts needed to meet immediate cash requirements. ____ ____ ____

f. Review selected cash reports submitted by subrecipients and determine if the reports show large amounts of excess cash. If they do, ascertain why. ____ ____ ____

5. Relocation Assistance and Real Property Acquisition

Compliance Requirements

Federal aid programs may require the acquisition of property by a public agency and subsequent displacement of households and businesses.

Grant recipients acquiring property in the administration of federal aid must carry out certain actions systematically, e.g., have property appraised in presence of owner, review appraisals, set price and negotiate settlements. Similarly, when displacement (relocations) are involved, the recipient must, for example, provide assistance systematically in locating replacement housing, assure that it meets acceptable standards and maintain records on all acquisitions and displacements (Uniform Relocation Assistance and Real Property Acquisition Policies Act of 1970 (URA) (Public Law 91-646 as amended by the Uniform Relocation Act Amendments of 1987, Title IV of Surface Transportation and Relocation Act of 1987 (1987 Amendments) Public Law 100-17, 100 Stat. 246-256 (see Common Rule Appendix B)).

Auditing Procedures

a. Ascertain whether the recipient is administering a federal or federally-assisted program that involves the acquisition of property or the displacement of households or businesses by a public agency. ____ ____ ____

b. Review the organization's system for compliance with relocation assistance and real property acquisition requirements and evaluate for adequacy. ____ ____ ____

c. Review the monitoring system for relocation and acquisition activity for selected programs and determine whether there is adherence to the prescribed procedures. ____ ____ ____

6. Federal Financial Reports

Compliance Requirement—Most federal programs require the periodic submission of financial reports that fall within one or more of the following three categories. The special requirement for each grant program is presented in the Reporting Requirements (III-D) section for that program. The suggested audit procedures are provided below to facilitate the requirements for the auditor to comment on completeness and accuracy [Section .41, "Uniform Administrative Requirements for Grants and Cooperative Agreements to State and Local Governments" (Common Rule) and Treasury Circular 1075, "Withdrawal of Cash from the Treasury for Advances under Federal Grant and Other Programs"]:

Obj.		Done By	Date	W/P Ref.

a. Section .41, "Uniform Administrative Requirements for Grants and Cooperative Agreements to State and Local Governments," list four required financial reports that apply to most of the programs described in this document.

(1) Financial Status Report (SF-269 or SF-269a)—Reports status of funds for all non-construction programs.

(2) Request for Advance or Reimbursement (SF-270)—Request funds for non-construction programs when advance letter of credit or predetermined advance payments are not used.

(3) Outlay Report and Request for Reimbursement for Construction Programs (SF-271)—Requests for reimbursements and reports status of funds for construction programs.

(4) Federal Cash Transaction (SF-272)—Reports cash transactions and balances for Grantees receiving cash by letter of credit or treasury checks.

b. Treasury Circular 1075 list two alternative cash management reports, one of which applies to each program financed through letters-of-credit:

(1) Request for Payment on Letter of Credit and Status of Funds Report (SF-183)

(2) Payment Voucher on Letter of Credit (TFS 5041).

c. Certain Federal agencies have received OMB approval to adapt the above reports or require other financial reports to meet their particular program needs.

Auditing Procedures

(1) Review the procedures for preparing the federal financial reports and evaluate for adequacy. ____ ____ ____

(2) Sample federal financial reports for each material program and review for completeness of submission. ____ ____ ____

(3) Trace data to the supporting documentation, i.e., worksheets, ledgers, etc. ____ ____ ____

(4) Review adjustments made to the general ledger amounts in the report affecting Federal programs and evaluate for propriety. ____ ____ ____

7. **Allowable Costs/Cost Principles**

Compliance Requirement (Direct and Indirect Costs)

The cost of a federally-supported program is comprised of the allowable direct cost of the program plus its allocable portion of allowable indirect costs less applicable credits. Federal cost principles are designed to provide that federally-assisted programs bear their fair share of recognized costs as determined by allowable cost principles. No provision for profit or other increment above cost is intended.

OMB Circular No. A-87, "Cost Principles for State and Local Governments," establishes principles and standards for determining costs applicable to grants, contracts, and other agreements with state and local governments and federally-recognized Indian Tribal governments. A cost is allowable for federal reimbursement only to the extent of benefits received by federal programs, and costs must meet the basic guidelines of allowability, reasonableness, allocability and remain the net of all applicable credits.

[OMB Circular No. A-87 is issued under the authority of the Budget and Accounting Act of 1921, as amended; the Budget and Accounting Procedures Act of 1950, as amended; Reorganization Plan No. 2 of 1920; and, Executive Order 11541.]

Obj.		Done By	Date	W/P Ref.

Auditing Procedures

For transactions selected by the auditor which involve federal funds, determine whether the costs meet the criteria set forth in the "Basic Guidelines" of Circular A-87, Attachment A, paragraph C, i.e., that the cost is:

a. Necessary and reasonable for the performance and administration of the federal program and be allocable thereto under the provisions of the Circular. _____ _____ _____

b. Authorized or not prohibited under state or local laws or regulations. Certain costs require specific approval by the grantor agency while some costs are not allowable as set forth in Circular A-87, Attachment A. _____ _____ _____

c. Conforms to any limitations or exclusions set forth in Circular A-87, or limitations in the program agreement or specific requirements in the program regulations. _____ _____ _____

d. Given consistent treatment with policies, regulations and procedures applied uniformly to federal and non-federal activities of the governmental unit. _____ _____ _____

e. Given consistent accounting treatment within and between accounting periods and not allocable to or included as a direct cost of a federal program if the same or similar costs are allocated to the federal program as an indirect cost. _____ _____ _____

f. Determined in accordance with generally accepted accounting principles. _____ _____ _____

g. Not included as a cost or used to meet cost sharing requirements of other federally-supported activity of the current or prior period. _____ _____ _____

h. Net of all applicable credits, e.g., volume or cash discounts, refunds, rental income, trade-ins, scrap sales, direct billings (in the case of indirect cost), etc. _____ _____ _____

i. Supported by underlying documentation, e.g., time and attendance payroll records, time and effort records for employees charged to more than one activity, approved purchase orders, receiving reports, vendor invoices, cancelled checks, etc., as appropriate, and is correctly charged as to program, account, amount and period. _____ _____ _____

Compliance Requirement (Indirect Costs Only)

In order to get reimbursed for indirect costs or centralized services, recipients must prepare cost allocation plans (CAP) and/or indirect cost rate proposals (IDCRP) that provide a basis for allocating indirect costs to federal programs. Each state, state department and major local unit of government, as well as any other organization specifically requested to do so, must submit its CAP/IDCRP to its cognizant agency for approval. Other unlisted organizations must prepare the appropriate plans/proposals and maintain them on file for later review but may use their results in the mean time.

CAPs and IDCRPs are usually prepared on a prospective basis using actual financial data from a prior year or budgeted data for the current year. When the actual costs for the year are determined the difference between the originally-proposed costs and the actual costs are either carried forward to a subsequent CAP/IDCRP or adjusted with the granting federal agency on a retroactive basis. In cases where fixed rates are determined and approved by the cognizant federal agency, subsequent adjustments are not made.

There are three types of plans/proposals:

Obj.		Done By	Date	W/P Ref.

a. *State and Local-Government-wide Cost Allocation Plans*—which describe the methods to be used for billing centralized services (such as computer centers, fringe benefits, motor pools, etc.) to individual user organizations/activities (referred to as Section II costs) and which allocate the costs of unbilled central services (such as accounting, personnel, etc.) to the individual user departments or activities (Section I costs).

b. *Departmental or Local Indirect Cost Rate Proposals*—which combine the billed or allocated costs (if any) from the state- or local-wide plan with the departmental or local level indirect costs and compute an indirect cost rate(s) to be used in charging indirect costs to direct programs and activities.

c. *Public Assistance Cost Allocations Plans*—which describe the methods to be used to allocate state- or local-wide allocated or billed indirect costs and departmental indirect, administrative, and operating costs of state or local welfare or human services organizations to the Medicaids, Food Stamps, Child Welfare programs, etc. These plans are required by the terms of 45 CFR Part 95 which incorporates Circular A-87 by reference and are required to be revised and submitted to the federal government whenever an organizational or programmatic change invalidates the currently approved approach.

Audit procedures must be tailored according to the size and type of organization being reviewed.

Auditing Procedures (General)

Determine whether indirect costs or centralized or administrative services are being charged to federal awards. If not, the rest of this section does not apply. If such costs are being charged, the following guidelines should be followed:

a. Obtain and read the current CAP and or Negotiation Agreement and determine the types of rates and procedures required. ____ ____ ____

b. Select a sample of claims for reimbursement submitted to the federal agency and determine if the amounts charged and rates used are in accordance with the plan and if rates are being properly applied to the appropriate base. ____ ____ ____

c. Determine whether the CAPs or IDCRPs have been approved by the appropriate federal agency and whether or not the resultant rates or amounts charged are final or are still open to adjustment or revision, either immediately or as a carryover adjustment in a future period. If approved and final, the results of the audit work shall be reflected, if appropriate, in recommendations for future procedural improvements. ____ ____ ____

d. Review on a test basis supporting documentation to determine whether:

(1) The indirect cost pool or centralized service costs contain only items that are consistent with the applicable cost principles and negotiated agreements. ____ ____ ____

(2) The methods of allocating the costs are in accordance with the provisions of Circular A-87, other applicable regulations and negotiated agreements. ____ ____ ____

(3) Statistical data (e.g., square footage, population, operating time, miles driven, case counts, salaries and wages) in the proposed allocation or rate bases are reasonable, updated as necessary and do not contain any material omissions. ____ ____ ____

[The next page is 5653-3.]

Obj.		Done By	Date	W/P Ref.

(4) Time studies or time and effort reports (where and if utilized) are mathematically and statistically accurate, are implemented as approved, and are based on the actual effort devoted to the various functional and programmatic activities to which the salary and wage costs are charged. ____ ____ ____

(5) The indirect costs charged to federal programs are supported by amounts recorded in the accounting records from which the most recently-issued financial statements were prepared. ____ ____ ____

(6) Other adjustments are made to compensate for differences between actual and estimated costs of fiscal years. ____ ____ ____

Auditing Procedures—State-Wide and Local-Wide Plans

a. For Section II (direct billed) services, determine whether:

(1) The rate base includes all users and treats them in a consistent manner. ____ ____ ____

(2) Any retained earning or unexpended earnings (including reserves) are present and, if so, determine: (a) if they have been computed in accordance with the applicable cost principles, (b) if they are excessive in amount, and (c) whether a refund has been made to the federal government for its fair share of any amounts thereof which have been removed (transferred out) or borrowed from the fund. ____ ____ ____

(3) Fringe benefit allocations, charges or rates deal fairly with differing levels, if any, of benefits provided to different classes of employees. ____ ____ ____

(4) Independent actuarial studies appropriate for self-insurance programs and certain types of fringe benefit programs are performed and, if so, are kept current. ____ ____ ____

b. Costs chargeable directly to federal grants or any other direct activity (including any costs required for matching or cost sharing) have been excluded from the pool of indirect costs and have been included in the base. ____ ____ ____

c. The users of services are billed in a consistent manner and billing rates (or charges) have been adjusted to eliminate profits and unallowable costs. ____ ____ ____

8. Drug-Free Workplace Act

Compliance Requirement

All grantees receiving grants, including cooperative agreements, from any federal agency must certify that they will provide a drug-free workplace, or, in the case of a grantee who is an individual, certify to the agency that his or her conduct of grant activity will be drug-free. Making the required certification has been a precondition of receiving a grant from a federal agency since March 18, 1989. Every grantee, except a state or state agency, is required to make this certification for each grant. A state or a state agency may elect to make a single annual certification to each federal agency from which it obtains grants if the federal agency has designated a central location for submission.

The grantee certifies that it will provide a drug-free workplace by:

a. Publishing a policy statement notifying employees that the unlawful manufacture, distribution, dispensing, possession or use of a controlled substance is prohibited in the grantee's workplace and specifying the actions that will be taken against employees for violation of such prohibition;

b. Establishing an ongoing drug-free awareness program to inform employees about:

(1) The dangers of drug abuse in the workplace;

Obj.		Done By	Date	W/P Ref.

(2) The grantee's policy of maintaining a drug-free workplace;

(3) Any available drug counseling, rehabilitation, and employee assistance programs; and,

(4) The penalties that may be imposed upon employees for drug abuse violations occurring in the workplace;

c. Making it a requirement that each employee to be engaged in the performance of the grant be given a copy of the statement required by paragraph a;

d. Notifying the employee in the statement required by paragraph a that, as a condition of employment under the grant, the employee will:

(1) Abide by the terms of the statement; and

(2) Notify the employer in writing of any criminal drug statute conviction for a violation occurring in the workplace no later than five calendar days after such conviction;

e. Notifying the agency in writing within ten calendar days after receiving notice under subparagraph d(2) from an employee or otherwise receiving actual notice of such conviction;

f. Taking one of the following actions, within 30 calendar days of receiving notice under subparagraph d(2), with respect to any employee who is so convicted:

(1) Taking appropriate personnel action against such an employee, up to and including termination; or

(2) Requiring such employee to participate satisfactorily in a drug abuse assistance or rehabilitation program approved for such purposes by a federal, state, or local health, law enforcement, or other appropriate agency.

[Public Law 100-690 Title V, Subtitle D, 41 USC 701 et seq.]

Auditing Procedures

a. Determine through discussions with employees and written communications to employees whether the grantee has taken action to provide a copy of the policy statement to each employee engaged in the performance of a grant. ____ ____ ____

b. Ascertain whether the statement contains all the necessary notifications. ____ ____ ____

c. Determine whether the grantee had established an ongoing drug-free awareness program which meets the requirements outlined above. ____ ____ ____

d. Determine whether the report made to federal grantor agencies on convictions of employees is filed and complete. ____ ____ ____

e. Test a sample of employee files and determine whether the report made to federal grantor agencies on convictions of employees is complete and if convictions were reported within 10 calendar days after the employer received any notice of an employee's conviction. ____ ____ ____

f. Ascertain whether the grantee took the required personnel or treatment referral action within 30 calendar days after receiving notice of an employee conviction. ____ ____ ____

Obj.	9. Administrative Requirements	Done By	Date	W/P Ref.

Federal assistance programs, with certain exceptions, are subject to the provisions of "Uniform Administrative Requirements for Grants and Cooperative Agreements to State and Local Governments" (Common Rule). The Common Rule does not apply to grants and subgrants to state and local institutions of higher education or state and local hospitals; block grants authorized by the Omnibus Budget Reconciliation Act of 1981; entitlement grants and other grants or payment programs specified in the Common Rule. These exceptions are specified in the Common Rule under the Applicability provisions of Subpart A.

Three Common Rule administrative requirements, financial reporting, cost principles and cash management principles, are covered elsewhere in this section. The auditor should also consider those common agency administrative requirements listed below from Subpart C of the Common Rule. Agency regulations for those grant program requirements not covered by the Common Rule are addressed in departmental regulations.

a. Interest earned on advances
b. Period of availability of funds
c. Program income
d. Real property
e. Equipment
f. Supplies
g. Subawards to debarred and suspended parties.
h. Procurement
i. Subgrants
j. Revolving fund repayments

Auditing Procedures

	Done By	Date	W/P Ref.
a. Determine the applicable administrative requirements that are material to the federal awards.	____	____	____
b. Review and evaluate internal controls in the administrative areas selected for review.	____	____	____
c. Test transactions for compliance.	____	____	____

This audit program section has been completed in accordance with firm policy.

	Date
Done by ________________	________
Reviewed by ________________	________

.160 XVI. Appendix A—Auditing and Reporting Concerns

During an audit engagement, the auditor should be aware that often there are signals that may indicate a potential audit or reporting problem. Some signals or indicators may suggest the need to modify audit procedures.

Listed below are examples of indicators the auditor may encounter in an audit of a governmental unit. It should be noted that the existence of a particular indicator does not necessarily mean there is a problem requiring extended audit procedures. The list, however, should be considered by the auditor in performing analytical procedures and in designing his/her audit procedures.

Items Highlighted Through Review of Financial Ratios or Statistics

- Revenue-based indicators:
  - Decreasing value of taxable property.
  - Increasing ratios of delinquent taxes to total tax levy.
  - Increasing ratios of maximum legal tax rates.
  - Increasing ratios of actual revenue below budgets.
  - Litigation relative to equalization of assessment actions.
- Expenditure-based indicators:
  - Increasing excesses of expenditures over revenues.
  - Increasing incidence of actual expenditures in excess of budgets.
  - Continuing increases in amount of unfunded vested benefits of pension programs.
- Cash management indicators:
  - Increasing amounts of aggregate short-term investments.
  - Increasing amounts of unpaid current obligations.
  - Decreasing income from short-term investments (that are not a result of falling interest rates).
- Debt Indicators:
  - Increasing ratio of bond indebtedness to total property value.
  - Increasing need to borrow to meet debt service requirements.
  - Increasing use of long-term debt to fund current expenditures.
  - Increasing amount of short-term borrowing remaining unpaid at the end of the fiscal year.

Nonfinancial Indicators

- Client Personnel:
  - Rapid turnover.
  - Management changes.
  - Weak financial personnel.
  - Unfilled positions due to budget limitations.

  - Internal auditors performing "special tasks" rather than auditing.
- Client relationships with auditors:
  - Accounting and reporting disputes.
- Weaknesses in accounting information system.
  - Lack of internal controls.
  - Poor cutoffs.
  - Reports not issued on a timely basis.
  - Inability to reconcile detailed records to general ledger balances.
  - Large number of exceptions in transactions or confirmations.
  - Client's inability to prepare meaningful analyses of activity.
  - Lack of timely or no budget status reports.
- External Considerations (e.g., economy, industry):
  - Large industrial plant closing or moving from community.
  - Environmental legislation or pressures.

.170 XVII. Appendix B—Federal Transaction Test Criteria

The following criteria are those that often are applied during the audit of federal transactions. Those criteria are presented as examples only. Judgment must be used to determine the test criteria to be applied to a particular federal program or transaction.

1. Was the expenditure contemplated in the approved budget?
2. Were only costs applicable to the Federal Financial Assistance Program charged?
3. Was the expenditure made in accordance with specific program compliance requirements and other limitations or exclusions in the federal assistance agreement?
4. Was the classification of direct or indirect charges in accordance with cost allocation plan(s) or grant agreements?
5. Was prior approval obtained from the federal granting agency, if appropriate?
6. Was there adequate documentation supporting the expenditure, including all authorization signatures, evidence of preaudits, etc?
7. Does the expenditure appear to be necessary and reasonable and "benefit" or assist in the accomplishment of the goals of the federally assisted program?
8. Was the expenditure properly coded and recorded?
9. Were capital expenditures properly recorded in the property records and identified as required by federal administrative guidelines, specific program compliance requirements, and federal assistance agreements?
10. Do assets acquired with the sample federal expenditure exist and are they being used for the purpose for which they were acquired?
11. Was the expenditure given consistent accounting treatment and applied uniformly and equitably to all benefitting activities/programs, both federally assisted and otherwise?
12. Was the expenditure net of any applicable credits?
13. Was the expenditure incurred during the authorized grant period or authorized extension thereto?
14. Were the charges incurred in accordance with competitive purchasing procedures, if applicable?
15. If an expenditure was a violation of any federal regulations or grant agreement terms and the auditee has asserted that such violations were approved by the federal grantor agency, was such approval documented in writing by the federal agency?

.180 XVIII. Appendix C—Criteria for Determining Questioned Costs

Criteria established to determine and report questioned costs vary from one federal agency to another. Many of the criteria are imposed by Congress at the time programs are authorized and funds are provided; however, other criteria are established through federal agency regulations. Generally, the criteria for determining and reporting questioned costs are as follows:

- *Unallowable costs.* Certain costs are specifically unallowable under the general and special award conditions or agency instructions. (They include, but are not limited to, pregrant and postgrant costs and costs in excess of the approved grant budget either by category or in total.)
- *Undocumented costs.* Costs are charged to the grant for which adequate detailed documentation does not exist, for example, to demonstrate their relationship to the grant or the amounts involved.
- *Unapproved costs.* Costs that are not provided for in the approved grant budget, or costs for which the grant or contract provisions or applicable cost principles require the awarding agency's approval, but for which the auditor finds no evidence of approval.
- *Unreasonable costs.* Costs incurred that may not reflect the actions that a prudent person would take in the circumstances, or assigning an unreasonably high valuation to in-kind contributions.

[The next page is 5701.]

AAM Section 5610

Suggested Supplemental Reference Materials for Use With Illustrative Audit Program for State and Local Governmental Units

.01 Suggested Supplemental Reference Materials

American Institute of Certified Public Accountants (AICPA)

Codification of Statements on Auditing Standards

Audit and Accounting Guide—*Audits of State and Local Governmental Units*

Audit and Accounting Guide—*Audit Sampling*

Audit Guide—*Consideration of the Internal Control Structure in a Financial Statement Audit*

Audit and Accounting Guide—*Audits of Employee Benefit Plans*

Audit Risk Alert—*State and Local Governmental Developments—1993*

Technical Practice Aids, sections 6930, 6950, 6955—Employee Health and Welfare Benefit Plans, State and Local Governmental Units, and Single Audit Act of 1984

Ethics Interpretation 501-3—"Failure to Follow Standards and/or Procedures or Other Requirements in Governmental Audits"

Statement of Position 92-7—*Audits of State and Local Governmental Entities Receiving Federal Financial Assistance*

Statement of Auditing Standards No. 68—*Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance*

Statements on Quality Control Standards—*System of Quality Control for a CPA Firm.*

Disclosure Checklists and Illustrative Financial Statements for State and Local Governmental Units.

Governmental Accounting Standards Board

Codification of Governmental Accounting and Financial Reporting Standards, June 30, 1993

Office of Management and Budget

Circular A-21: *Cost Principles for Educational Institutions* (10-91)

Circular A-50 Revised: *Audit Follow-up* (9-82)

Circular A-87 Revised: *Cost Principles for State and Local Governments* (1-81) (Formerly FMC 74-4)

Circular A-102: *Uniform Administrative Requirements for Grants and Cooperative Agreements to State and Local Governments* (March 11, 1988)

Circular A-128: *Audits of State and Local Governments* (4-85)

Questions and Answers on the Single Audit Provisions of OMB Circular A-128 "Audits of State and Local Governments"—November 1987

Catalog of Federal Domestic Assistance

Compliance Supplement for Single Audits of State and Local Governments—*Uniform Requirements for Grants to State and Local Governments* (Revised September 1990)

General Accounting Office

Government Auditing Standards (1988 Revision)

Interpretation of Continuing Education Training Requirements (April 1991)

U.S. Department of Education

Audits of Student Financial Assistance Programs (March 1990)

President's Council on Integrity and Efficiency (Single Audit Committee)

Federal Cognizant Agency Audit Organization Guidelines (including PCIE Position Statements)

Study on Improving the Single Audit Process (September 1993)

Other

Public Law 98-502, Single Audit Act of 1984

Intergovernmental Cooperation Act

Uniform Administrative Requirements for Grants and Cooperative Agreements to State and Local Governments—"Common Rule"—Published March 11, 1988, Federal Register with individual Federal Agency Actions

Applicable Federal Rules and Regulations

Applicable State Laws and Administrative Rules and Regulations

Local Government Charter

Local Laws, Rules, and Regulations

[The next page is 6001.]

AAM Section 6000

WORKING PAPERS

Sample and blank working papers are presented for illustrative purposes only. They are intended as mere conveniences for users of this Manual who may want points of departure when designing their own formats to meet their individual needs. These illustrations are neither all-inclusive nor prescribed minimums. Auditors and accountants are to rely on professional standards and their individual professional judgment in determining the workpapers needed in the circumstances.

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AAM Section 6100
Working Papers—General

.01 Working papers serve both as tools to aid the auditor in performing his work, and as written evidence of the work done to support the auditor's report. SAS No. 41, *Working Papers* (AU section 339), provides authoritative guidance on the functions and nature, general content, and ownership and custody of working papers.

General Discussion

.02 These sections present points of view on the organization and preparation of working papers and include selected illustrations of working papers, primarily analyses and schedules.

.03 Proper planning is important in the design of specific working papers if they are to serve the objective of aiding the auditor in the conduct of his work. For example, a well-planned working paper may be designed to provide information that will be needed later in the preparation of tax returns and other required reports, such as those to regulatory bodies, and may therefore eliminate the need for examining the same documents twice to obtain necessary information. The format and content of the working papers may vary with the individual preferences of auditors and firms. These preferences may be informal common practices or expressed as part of a firm's formal written policies and procedures. A firm should consider the nature of its practice and the services commonly provided to its clients, as well as professional standards in developing its procedures and policies on working papers. Those procedures and policies should permit the flexibility necessary to meet the needs of individual engagements.

[The next page is 6201.]

AAM Section 6200
Basic Elements of Format

.01 Working paper formats generally include at least the following for identification purposes:

- A title or heading comprised of (a) the name of the client, (b) a caption that briefly describes the paper's contents, (c) the nature of the engagement, and (d) the applicable period or closing date covered by the engagement.
- The initials or names of the auditors who performed and reviewed the work presented in the paper and the date the paper was completed.

.02 In instances when one working paper requires more than one page, some auditors present the heading on only the lead page, fasten or staple all the applicable pages together as a unit and number each page, for example, 1 of 5, 2 of 5, and so forth. Many auditors index each working paper in some organized pre-established manner. This provides for ease in cross-referencing to other relevant papers, for more organized indexing and filing, and for a form of control over the working papers. (See AAM section 6400.)

.03 Some auditors purchase standard analysis paper that includes preprinted blocks for the initials or signature of the preparer and reviewer, and the dates on which the paper was prepared and reviewed. Others design their own signature and reference blocks and have them imprinted on all of their analysis paper and lined pads. These signature blocks may include captions such as the following:

—prepared by client and tested by

—prepared by

—date prepared

—date tested

—reviewed by

—date reviewed

—source

—work paper reference

—footed by

—extensions checked by

.04 Some auditors prefer to identify client preparation of schedules and analysis by notations or codes, such as "PBC," for prepared by client, rather than use a detailed signature and reference block.

[The next page is 6301.]

AAM Section 6300
Content of Working Papers

.01 The content of working papers varies with the circumstances and needs of the auditors on individual engagements. Some firms, however, include various general and specific instructions on working paper content in their policies concerning working papers.

General Considerations

.02 The following are some general considerations on working paper content that may be helpful.

- Working papers should be sufficiently intelligible, clear and neat so that another auditor who has had no previous association with the engagement can review the papers and determine the nature and extent of the work done and how the conclusions were reached that support the resulting auditor's report.
- The content of an individual working paper or group of related papers should include identification of the (1) source of the information presented (e. g., fixed assets ledger, cash disbursements journal), (2) the nature and extent of the work done and conclusions reached (by symbols and legend, narrative, or a combination of both), and (3) appropriate cross-references to other working papers.
- Before completion of the engagement, all questions or exceptions in the working papers should be resolved. If for some reason the auditor must leave the assignment without resolving all items, he should provide an open items listing on a separate temporary paper for the in-charge auditor's attention. An unresolved exception or incomplete explanation in the working papers may be construed by some as indication of an inadequate audit.
- Information and comments in the working papers generally represent statements of fact and professional conclusions. Accordingly, language should be clear and free from such vague judgmental adjectives as "good" or "bad." Conclusions should be supported by documented facts, especially if they concern the adequacy of the client's records.
- Working papers should be viewed as an integrated presentation of information. The auditor should cross-reference working papers to call attention to interaccount relationships and to reference a paper to other working papers summarizing or detailing related information.
- The preparer should view the working papers as if he were the in-charge auditor. All inferences and conclusions should be supported in the working papers and no misleading or irrelevant statements should be made.
- It is preferable to have negative figures in working papers indicated by parentheses instead of red figures to preserve their identity if the papers are photocopied or microfilmed.

Timesaving Considerations

.03 There are a number of ways to save time and avoid unnecessary detail in working paper preparation. The following examples may be helpful.

- Whenever possible, have the client's employees prepare schedules and analyses. (This, of course, presupposes that the client has the necessary personnel to prepare the materials.)
- Use of a detailed audit program may eliminate the need for lengthy comments in the working papers on the scope of audit procedures. (However, some believe that such comments are still necessary when a detailed program is used; this is a matter of individual firm judgment.)

- Analyze asset (or liability) accounts and their related expense or income accounts on the same working paper. Examples include property, plant, and equipment, accumulated depreciation and related depreciation expense; notes receivable, accrued interest receivable and interest income; notes payable, accrued or prepaid interest, and interest expense; and accrued taxes and related provisions for tax expense.
- Avoid unnecessary computations. For example, if only the totals are meaningful and can be tested by a single independent computation, check the total and avoid unnecessary checking of details.
- Consider using carryforward analyses for accounts that tend to remain constant each year or vary only in accordance with a constant predetermined formula. Examples may include long-term assets and related depreciation or amortization such as plant, equipment, and intangibles, long-term debt with predetermined payment schedules, and capital stock.
- Consider using adding machine tapes instead of writing separate lists. Enter names or explanations on the tapes, when appropriate.
- Do not manually copy a document when photographic reproduction is feasible.
- If in doubt, use a larger sheet of paper—an unused portion is less of a problem than running out of space.
- Use symbols (tick marks) whenever possible, especially when the same symbol applies to several working papers.

Symbols (Tick Marks)

.04 When using symbols, it should be helpful to consider the following basic concepts:

- Symbols are merely a shorthand means of explaining a work step performed on a particular item of data. Symbols serve as means of conserving time and space and, if properly used, may ease review of the working papers.
- For a working paper to be clear to a reviewer or other reader, each symbol must be clearly explained. The explanation may be located on the same page as the items subjected to the work step, or on a separate legend that is clearly cross-referenced to and from the page that presents the applicable items.
- Symbols should be kept simple, distinctive and clear so they can be quickly written by the preparer and easily identified by a reviewer.

.05 Applying these basic concepts is not that simple. Various auditors have conflicting notions about symbols. For example, on the matter of color, some believe all tick marks should be in color to make it easy to spot them in the working papers. Others believe it is a waste of time to keep "switching pencils" and observe that the color distinction is lost in photocopying. On another matter, some believe a set of standardized symbols can expedite preparation and review. Others believe that a set of standardized symbols is impractical because it lacks flexibility. Because it is generally agreed that symbols are an effective timesaver, it is desirable for firms to establish and communicate a policy on their use to maximize their potential effectiveness.

.06 Commonly used symbols, as noted, should be simple and distinctive, not elaborate hieroglyphics. The most common are variations on a simple checkmark—for example, a checkmark with a slash, a checkmark with a circle at the end, a double checkmark, and any one of these within a circle. This abbreviated listing alone provides eight distinctive tick marks. Symbols may also include circled letters or numbers.

[The next page is 6401.]

AAM Section 6400
Organization and Filing (Indexing)

.01 Some auditors organize their working papers during the course of an engagement into general categories such as the following:

- Planning and administration.
- Internal control structure understanding and assessment of control risk.
- Substantive test working papers arranged in order of the balance sheet and income statement classifications.
- Trial balances, consolidating working papers, journal entries (adjustments, reclassifications, eliminations for consolidation), and potential entries.
- Draft reports, financial statements, and notes.
- Programs, checklists, and questionnaires (some keep these as separate units, others interfile them among working papers by statement classifications).
- General matters such as current minutes, contracts, and articles of incorporation that may apply to future engagements as well as current work.

Under this approach, actual indexing and filing would be deferred until the conclusion of the engagement.

Predetermined Indexing

.02 Other practitioners and firms may use a predetermined indexing approach so that working papers can be indexed while the field work is still in progress. This offers the following advantages:

- Better control over working papers during the performance of field work.
- Constant arrangement of working papers in logical order to aid in review.
- Less time required in assembling and binding them into indexed files.
- Quicker access to specific working papers after they are filed.

.03 Predetermined indexing involves establishing a standard code for each section of the working papers, using letters and numbers, or numbers only. For example—

	Two Possible Alternatives	
Working trial balance—assets	B/S-A	T/B-1
Working trial balance—liabilities	B/S-L	T/B-2
Working trial balance—income & expense	P/L	T/B-3
Cash summary schedule	A	10
Receivables summary schedule	B	20
Inventory summary schedule	C	30

.04 Predetermined indexing requires recognition of the need for flexibility to meet unanticipated working paper needs or specialized industry requirements and it requires care to avoid undue complexity. Excessively complex references may obstruct rather than ease working paper preparation, cross-referencing and filing. Accordingly, it is helpful to develop an organizational plan adaptable to each section of the working papers. For example, some accountants classify working papers as lead schedules, primary detail, and secondary detail which might result in the following classification scheme for the above examples for cash:

	Using Letters and Numbers	Using Only Numbers
Lead schedule	(A)	(10)
Primary detail schedules	(A-1) (A-2) etc.	(10-1) (10-2) etc.
Secondary detail schedules	(A-1-1) (A-1-2) (A-1-3)	(10-1-1) (10-1-2)
	(A-2-1) (A-2-2) (A-2-3)	(10-2-1) (10-2-2)

.05 Predetermined (standardized) indexing systems may be printed on separate pages for reference during the performance of field work and insertion in the front of working paper binders or files when the work is completed. Some firms have their uniform indexing systems printed directly on their file or binder covers.

.06 A well-organized indexing system need not be too complex. On a fairly small engagement, the indexing system may be a lead schedule divider tab between each major group of accounts with the name of the account on it (e.g., cash or accounts receivable) with the related workpapers filed behind the lead schedule without being individually indexed. At the completion of the engagement, the pages can be consecutively numbered within each account group (e.g., 1 of 10, 2 of 10, etc.), since there typically are not numerous or complex layers of supporting schedules, extensive cross-referencing can be avoided.

.07 On large engagements, particularly those with detailed charts of accounts, firms may consider it necessary to develop more complex indexing systems. In one such system, standard index number series are assigned as follows:

Current workpaper file	1000—7000
Permanent file	7100—9999

.08 In this system, each index number consists of four digits, with the addition decimals if necessary. Numbers ending with double zero are reserved for lead schedules whose total agrees with a line item on the working trial balance (index 1400). Single zeros are used for specific types of accounts (such as 2010, petty cash funds).

.09 Certain index numbers can be permanently assigned to each major financial statement classification. For instance, index 2000 may be assigned to cash. If various bank accounts exist, the cash schedules are assigned index numbers 2002, 2003, etc. Documentation such as supporting confirmations and lists of outstanding checks would be assigned index numbers commencing with 2001.1, 2001.2, etc. As for the permanent workpaper file, index 9300, for example, may be assigned to internal control structure. Accordingly, flowcharts and related questionnaires would be assigned index numbers in that series.

Current and Permanent Files

.10 Working paper files are generally classified as current files and permanent (continuing) files. Current files contain information that is pertinent to a single engagement. Permanent files include information relevant to several recurring engagements. Some firms have their binder or file covers preprinted as current or permanent accompanied by pertinent portions of their uniform working paper indexes.

.11 A common challenge to many auditors is to keep the permanent file complete and current, and free from outdated or irrelevant materials that belong in an inactive file of superseded materials.

.12 Some auditors who have confronted one too many unwieldy permanent files believe all working papers should be classified as current with certain materials designated as matters of continuing interest to be carried forward each year until they become outdated. Under this approach, a firm may preprint its complete index on one type of file or binder cover and provide space to indicate whether specific contents are continuing or carry-forward in nature.

Index Topics

.13 The following is a list of topics to consider in developing a standard index for working papers. This list is detailed, but is by no means all-inclusive. For example, specialized industries such as life insurance and banking need other specialized topics. Several of the topics may be eliminated, condensed or expanded, depending on the auditor's needs and preferences. Topics that some auditors prefer to include in both the permanent and current files or only in the permanent files are followed by the letter (P).

Planning and administration

. Time & budget data

. General correspondence & memos

. Planning memos—current

. Planning notes & confirm copies for use in next engagement

. Engagement letters

. Schedules & analyses to be prepared by client

. Minutes

. Checklist of an administrative nature if required by firm policy

Audit or work program (Note 1)

Matters of continuing concern

. Client's industry—background (P)

. Description & brief history of client (P)

. Data & ratio analysis of client's operations (P)

. Client's facilities (P)

. Articles of incorporation (P)

. Bylaws (P)

. Current contracts & agreements (P)

. . Debt agreements (P)

. . Leases (P)

. . Labor contracts (P)

. . Agreements with officers & key people (P)

. . Pension plans (P)

. . Profit-sharing plans (P)

. . Stock warrants (P)

. . Stock options (P)

. . Other agreements (P)

. Client's accounting policies & procedures (P)

. Carryforward analyses (Note 2)

Internal control structure

. Internal control structure questionnaire, narratives, flow charts, etc. (Note 3)

. Initial assessment of control risk memos

. Tests of controls

Reports, financial statements and footnotes, trial balances, and assembly sheets

. Reports & financial statements (including letter, if any, on reportable conditions in internal control structure)

. Consolidating working papers

. Consolidation eliminating entries

. Trial balance

. Adjusting journal entries

. Reclassification journal entries

. Recap of possible adjusting entries

. Assembly sheets supporting footnote disclosures (if the information is not included elsewhere in the working papers)

. Disclosure checklists (if required by firm policy)

. Supporting schedules (if required for reports to regulatory bodies or other reports)

. Tax return information & work sheets (Note 4)

Assets

. Cash

. Marketable securities (and related income)

. Notes receivable (and related interest)

. Accounts receivable

. . Summary and analyses

. . Confirmation procedures (Notes 2 and 5)

. Allowance for doubtful accounts & notes (Note 2)

. Inventories

. . Summary and analyses

. . Price tests, cost & market

. . Obsolescence review

. . Observation, test counts & cutoff data

. . LIFO determinations

. Prepaid expenses

. Other current assets

. Investments

. Property, plant & equipment, and accumulated depreciation, depletion & amortization (Note 2)

. Intangible assets, deferred charges & amortization (Note 2)

. Other assets

. Intercompany accounts

Liabilities

. Notes payable (and related interest)

. Accounts payable

. Accrued liabilities other than income taxes

. Accrued income taxes (current & deferred), related provisions & credits (Note 2)

. . Federal

. . State & local

. Other current liabilities

. Long-term debt (including current maturities and capitalized leases) (Note 2)

. Other long-term liabilities

. Deferred income (Note 2)

Commitments and contingencies

. Attorneys' letters

. Abstracts of commitments & contingencies noted during review of minutes, contracts & agreements, confirmation responses, etc.

. Subsequent events review

. Management representation letter

Equity (capital accounts) (Note 2)

. Capital stock

. Additional paid-in capital

. Treasury stock

. Retained earnings

. Partnership capital

Revenue and expenses

. Operating revenues

. Cost of sales

. Selling, general & administrative

. Other operating expenses

. Other income

. Other expense

. Extraordinary & unusual items

. Secondary schedules

. . Maintenance & repairs

. . Taxes other than income taxes

. . Rents

. . Royalties

. . Advertising costs

. . Legal fees

. . Interest expense recap

NOTES TO USER:

1. Alternate practices of filing audit programs include:

   (a) Putting the program in a binder that is separate and distinct from the current and permanent files.

   (b) Putting the signed off program in the current file.

   (c) Keeping a master copy of the program in the permanent file with the signed off copies dispersed among the related working paper segments in the current file.

2. Certain classifications may lend themselves to carry-forward working papers. Examples include allowances for doubtful accounts, brief summaries of confirmation response statistics, accumulated depreciation and amortization, deferred income taxes and open tax positions, long-term debt, and capital accounts.

3. Internal control structure questionnaires may be filed as separate binders or as part of current or permanent files.

4. Some firms and practitioners keep tax return preparation working papers in files that are completely separate from other types of engagement working papers.

5. For situations involving voluminous confirmation responses or bulk inventory listings, the bulk materials may be filed in separate binders that are cross referenced to the pertinent working papers (for example: accounts receivable, accounts payable, and inventory).

[The next page is 6501.]

AAM Section 6500
Sample Working Papers

.010 The samples of individual working paper formats included in this section are for illustrative purposes only. Blank working papers are provided as "tools" and in no way represent official positions or pronouncements of the AICPA. These working papers do not represent minimum requirements and do not purport to be all-inclusive. They should be used by or under the supervision of persons having adequate technical training and proficiency in the application of generally accepted accounting principles, generally accepted auditing standards, and Statements on Standards for Accounting and Review Services. Users of these working papers are urged to refer directly to applicable authoritative pronoucements when appropriate.

General Comment

.020 These illustrations are included to help users of the manual save time by using them as points of departure in designing their own formats to meet their individual needs. For example, the analysis formats included among the samples tend to present a single step of activity between balances at the opening and closing dates of a fiscal year. If an auditor decides to do substantive testing prior to a fiscal year end, he may wish to use analysis formats that show activity between balances at the opening date of a fiscal year and a preliminary date during the year, and another step of activity from the preliminary date to the fiscal year end. Also the analysis formats in this section tend to present balance and activity captions as column headings with components shown on the line items as follows:

Description	Opening balance	Expense provision	Disburse-ments	Closing balance
	xxx	xxx	(xxx)	xxx
	xxx	xxx	(xxx)	xxx
	___	xxx	(xxx)	xxx
Totals	xxx	xxx	(xxx)	xxx

An alternate approach would be to present balance and activity captions as line items and use the column headings for components as shown in the following example:

		Components		
	Totals	...	...	...
Opening balance	xxx	xxx	xxx	___
Expense provision	xxx	xxx	xxx	xxx
Disbursements	(xxx)	(xxx)	(xxx)	(xxx)
Closing balance	xxx	xxx	xxx	xxx

.030 The decision as to appropriate format must be made by the individual auditor after considering all the circumstances of the engagement.

ABC Co.
.040 Assembly Sheet - Balance Sheet
12/31/X5

Prepared By
Approved By
Initial Date

(1) Working paper ref.(B)	(2) Classifications (A)(F)	(7) Final balance(C) 12/31/X4	(8) Per client(C) 12/31/X5
	Current assets:		
A	Cash		
B	Marketable securities		
C	Accounts receivable		
D	Less, allowance for doubtful accounts	( )	( )
	Net		
E	Inventories - raw materials		
	- supplies		
	- work-in-process		
	- finished goods		
	Total		
F	Prepaid expenses		
F	Other current assets		
	Total current assets		
B	Other security investments		
B	Less, valuation allowance	( )	( )
J	Property plant & equipment, at cost		
	Land		
	Buildings		
	Machinery & equipment		
	Furniture & fixtures		
	Leasehold improvements		
	Less, accumulated depreciation & amortization		
	Buildings	( )	( )
	Machinery & equipment	( )	( )
	Furniture & fixtures	( )	( )
	Leasehold improvements	( )	( )
		( )	( )
	Net		
K	Other assets - Cash surrender value		
	- Intangible assets		
	- Other		
	TOTAL ASSETS		

(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
Adjusting Entries (D)		Balances as adj.	Reclassification Entries (E)		Final for report (F)	Remarks	
Dr.	Cr.	12/31/X5	Dr.	Cr.			

NOTES:

(A) Financial statement assembly sheets generally include the same captions (classifications) as the financial statements. For comparison purposes they also show the final amounts reported for the preceding year. For convenience, some auditors may include additional detail in support of the statement classifications on their assembly sheets.

The amounts for each caption would be supported by comparative lead sheets in each grouping of substantive test working papers. These lead sheets provide a trail to evidence of the work done and show comparatively how specific amounts in the client's accounts are grouped for classification in the financial statements for both the current year and as reported for the preceding year. (However, see the sample "Working Trial Balance" for an alternative approach)

(B) The column "work paper ref." in this illustration may include specific indexing codes used in a predetermined indexing approach.

(C) The final balances for the preceding year (12/31/X4 in this illustration) would be obtained from last year's audit report for the assembly sheets, and from last year's working papers for the supporting comparative lead sheets. The per client balances for the current engagement would be developed from the supporting comparative lead sheets which have been agreed to the client's general ledger.

(D) Adjusting entries would be posted to the comparative lead sheets and grouped. Then the grouped adjustments would be posted from the comparative lead sheets to these assembly sheets. The adjusted balances on the lead sheets as of 12/31/X5 would agree with the client's final account balances after posting of the adjusting entries.

(continued)

ABC Co.

Assembly Sheet - Balance Sheet (continued)

12/31/X5

	Initials	Date			
Prepared By					
Approved By					

(1)	(2) (3) (4) (5) (6)	(7)	(8)
Work paper ref. (B)	Classifications (A) (F)	Final balance (C) 12/31/X4	Per client (C) 12/31/X5
	Liabilities		
	Current Liabilities:		
N	Notes payable		
O	Accounts payable		
P	Accrued expenses		
Q	Income taxes		
Q	Deferred income taxes - current portion		
R	Other Current Liabilities		
S	Current Portion of Long-Term Debt		
	Total Current Liabilities		
S	Long-Term Debt		
Q	Deferred Income Taxes		
	Total Liabilities		
	Stockholders' Equity:		
X	Common Stock		
X	Paid-in Capital		
Y	Retained Earnings		
	subtotal		
Z-1	Less, cost of common stock in treasury		
	Stockholders' equity		
	Total Liabilities and Stockholders' Equity		

(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
Adjusting Entries (D)		Adjusted Balance	Reclassification Entries (E)		Final for report (F)	Remarks	
Dr.	Cr.	12/31/X5	Dr.	Cr.	12/31/X5		

NOTES: (continued)

(E) Columns are also provided for reclassification entries that may be needed for financial statement purposes but do not need to be posted to the client's accounts.

(F) The amounts presented in the assembly sheets and supporting comparative lead sheets should be consistent and clearly cross-referenced.

	Initials	Date
Prepared By		
Approved By		

.041 *Assembly Sheet - Balance Sheet*

(1) Working paper ref.	(2) Classifications	(3)	(4)	(5)	(6)	(7) Final balance	(8) Per client
	Current assets:						
	Cash						
	Marketable securities						
	Accounts receivable						
	Less, allowance for doubtful accounts					( )	( )
	Net						
	Inventories - raw materials						
	- supplies						
	- work-in-process						
	- finished goods						
	Total						
	Prepaid expenses						
	Other current assets						
	Total current assets						
	Other security investments						
	Less, valuation allowance					( )	( )
	Property plant & equipment, at cost						
	Land						
	Buildings						
	Machinery & equipment						
	Furniture & fixtures						
	Leasehold improvements						
	Less, accumulated depreciation & amortization						
	Buildings					( )	( )
	Machinery & equipment					( )	( )
	Furniture & fixtures					( )	( )
	Leasehold improvements					( )	( )
						( )	( )
	Net						
	Other assets - Cash surrender value						
	- Intangible assets						
	- Other						
	TOTAL ASSETS						

(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
Adjusting Entries		Balances as adj.	Reclassification Entries		Final for report	Remarks	
Dr.	Cr.		Dr.	Cr.			

	Initials	Date
Prepared By		
Approved By		

Assembly Sheet - Balance Sheet (continued)

(1) Work paper ref.	(2)(3) Classifications	(4)	(5)	(6)	(7) Final balance	(8) Per client
	Liabilities					
	Current Liabilities:					
	Notes payable					
	Accounts payable					
	Accrued expenses					
	Income taxes					
	Deferred income taxes - current portion					
	Other Current Liabilities					
	Current Portion of Long-Term Debt					
	Total Current Liabilities					
	Long-Term Debt					
	Deferred Income Taxes					
	Total Liabilities					
	Stockholders' Equity:					
	Common Stock					
	Paid-in Capital					
	Retained Earnings					
	subtotal					
	Less, cost of common stock in treasury					
	Stockholders' equity					
	Total Liabilities and Stockholders' Equity					

(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
Adjusting Entries Dr.	Cr.	Adjusted Balance	Reclassification Entries Dr.	Cr.	Final for report	Remarks	

.050

ABC Co.
Assembly Sheet - Results of Operations, Retained Earnings
12/31/X5

	Initials	Date
Prepared By		
Approved By		

(1) W.P. ref.	(2)–(6) Classifications (A)	(7) Final Balances 12/31/X4	(8) Per client 12/31/X5
AA-1	Net sales		
BB-1	Cost of sales*		
BB-2	Research & development*		
CC-1	Selling, general & administrative expenses*		
	Subtotal before other income & expense		
	Other income & expense		
B-2	Dividend income		
EE	Interest expense		
GG-1	Other expense		
	Net		
	Total expenses before inc. taxes		
	Income before income tax provisions		
	Provision for income taxes		
Q	Current - federal		
	- state		
	subtotal		
	Deferred - federal		
	- state		
	subtotal		
	NET INCOME		
Y	Retained earnings - beginning of year		
Y	Less - Dividends		
Y	Retained earnings, end of year		
	*Memo - Depreciation included above in		
BB-1	Cost of sales		
BB-2	R&D		
BB-3	SG&A		
J-1	Total		

(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
Adjusting Entries		*Balances as adj. 12/31/X5*	*Reclassification Entries*		*Final for Report*	*Remarks*	
Dr.	*Cr.*		*Dr.*	*Cr.*			

NOTES:

(A) Each classification should be supported by a comparative lead sheet. This illustration includes the following assumptions.

- Research and development costs are of enough significance to require a separate caption.
- ABC Company is not required to report segment information or earnings per share.
- Depreciation expense is not to be disclosed in the statement of cash flows; the auditor also noted depreciation expense on this working paper as a memo for his convenience.

(B) See SAS No. 23 for guidance on analytical review procedures.

.051

Assembly Sheet - Results of Operations, Retained Earnings

	Initials	Date
Prepared By		
Approved By		

(1) W.P. ref.	(2)–(6) Classifications	(7) Final Balances	(8) Per client
	Net sales		
	Cost of sales*		
	Research & development*		
	Selling, general & administrative expenses*		
	Subtotal before other income & expense		
	Other income & expense		
	Dividend income		
	Interest expense		
	Other expense		
	Net		
	Total expenses before inc. taxes		
	Income before income tax provisions		
	Provision for income taxes		
	Current - federal		
	- state		
	subtotal		
	Deferred - federal		
	- state		
	subtotal		
	NET INCOME		
	Retained earnings - beginning of year		
	Less - Dividends		
	Retained earnings, end of year		
	*Memo - Depreciation included above in		
	Cost of sales		
	R&D		
	SG&A		
	Total		

(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
Adjusting Entries		Balances as adj.	Reclassification Entries		Final for Report	Remarks	
Dr.	Cr.		Dr.	Cr.			

INDIRECT METHOD

.060 DEF Company

Cash Flows Worksheet (A)

12/31/X5

	Date	Prepared By	Work Paper No
		Reviewed By	

From Other WP REFS.	Assembly Sheets For Reported Balance Sheet and Other WPs		(B) 12/31/X4	(B) 12/31/X5	Net Change (C) DR <CR>
	Cash		10000	5000	<5000> (D)
	Marketable Securities		50000	60000	10000
	Accounts Receivable, Net		400000	500000	100000
	Inventory		300000	350000	50000
	Prepaid Expenses & Other Current Assets		10000	15000	5000
(J-1)	Property Plant and Equipment At Cost		500000	650000	150000
	Accumulated Depreciation		<100000>	<130000>	<30000>
	Other Assets		50000	55000	5000
	Total Assets		1220000	1505000	
	Notes Payable		100000	130000	<30000>
	Accounts Payable		100000	110000	<10000>
	Accrued Expenses		20000	30000	<10000>
	Income Taxes		40000	50000	<10000>
	Deferred Income Taxes - Current Portion		20000	30000	<10000>
	Other Current Liabilities			5000	<5000>
	Current Portion - Long Term Debt		20000	30000	<10000>
(S-1)	Long Term Debt		260000	300000	<40000>
(Q-1)	Deferred Income Taxes		60000	80000	<20000>
(X-1)	Capital Stock		100000	120000	<20000>
	Additional Paid In Capital		100000	120000	<20000>
	Retained Earnings	Memo Analysis			
	12/31/X4	400000	400000		
	Net Income	200000			<200000>
	Dividends	<100000>			100000
	12/31/X5	500000		500000	
	Total Liabiliites & Equity		1220000	1505000	
	Proof				-0-

Notes:

(A) This working paper supports the Statement of Cash Flows (Indirect Method). Propoents of this schedule believe that taking shortcuts may often lead to excessive preparation time (not being able to reconcile because of omissions, etc.) and review time (unable to cross reference back to sources).

5 Net Income, Depreciation & Amortization	6	
	50000	Retirements
<60000>	(30000)	of PP & E
	20000	
<200000>		

(B) Use final amounts to be reported in Balance Sheet.

(C) Before spreading changes for analysis purposes, the increases and <decreases> column should be footed and balanced to zero.

.061

INDIRECT METHOD

	Date	Prepared By	Work Paper No
		Reviewed By	

Cash Flows Worksheet

From Other REFS.	Assembly Sheets For Reported Balance Sheet and Other WPs	1	2	3	4 Net Change DR <CR>
	Cash				
	Marketable Securities				
	Accounts Receivable, Net				
	Inventory				
	Prepaid Expenses & Other Current Assets				
	Property Plant and Equipment At Cost				
	Accumulated Depreciation				
	Other Assets				
	Total Assets				
	Notes Payable				
	Accounts Payable				
	Accrued Expenses				
	Income Taxes				
	Deferred Income Taxes - Current Portion				
	Other Current Liabilities				
	Current Portion - Long Term Debt				
	Long Term Debt				
	Deferred Income Taxes				
	Capital Stock				
	Additional Paid In Capital				
	Retained Earnings	Memo Analysis			
	Net Income				
	Dividends				
	Total Liabiliites & Equity				
	Proof				

5	6	7	8	9	10
Net Income, Depreciation & Amortization					

Date	Prepared By	Work Paper No
	Reviewed By	

DEF Company

.062 Cash Flow Statement Worksheet (E)

12/31/X5

Item	1	2	Operating Activities Inflow	Operating Activities Outflow
Net Income			200000	
Depreciation			60000	
Changes in Non Cash Current Accounts:				
Increase in Marketable Securities				
Increase in Accounts Receivable				100000
Increase in Inventory				50000
Increase in Prepaids and other Current Assets				5000
Increase in Notes Payable				
Increase in Accounts Payable			10000	
Increase in Accrued Expenses			10000	
Increase in Income Taxes			10000	
Increase in Deferred Income Taxes			10000	
Increase in other Current Liabilities			5000	
Increase in Current Portion of Long Term Debt				
Changes in Non Current Assets:				
Purchase of Equipment				
Retirement of Equipment				
Increase in Other Assets				5000
Changes in Non Current Liabilities and Equity				
Increase in Long Term debt				
Increase in Deferred Income Taxes			20000	
Proceeds from Sale of Stock				
Dividends Paid				
			325000	160000
Net Cash Flows			165000	
Net Increase <Decrease> in Cash (D)			<5000>	

Notes:

(D) Net increase <decrease> in cash must prove to net increase <decrease> in reported balance sheet amounts of cash

(E) This working paper is prepared in addition to the statement of cash flows worksheet when the direct method is used because SFAS No. 95 requires the presentation of a reconciliation of net income to net cash provided (used) by operating activities.

Investing Activities Inflow	Investing Activities Outflow	Financing Activities Inflow	Financing Activities Outflow
	10000		
		30000	
		10000	
	200000		
20000			
		40000	
		40000	
			100000
20000	210000	120000	100000
	<190000>	20000	

Date	Prepared By	Work Paper No
	Reviewed By	

.063 Cash Flow Statement Worksheet

Item	1	2	3 Operating Activities Inflow	4 Operating Activities Outflow
Net Income				
Depreciation				
Changes in Non Cash Current Accounts:				
in Marketable Securities				
in Accounts Receivable				
in Inventory				
in Prepaids and other Current Assets				
in Notes Payable				
in Accounts Payable				
in Accrued Expenses				
in Income Taxes				
in Deferred Income Taxes				
in other Current Liabilities				
in Current Portion of Long Term Debt				
Changes in Non Current Assets:				
Purchase of Equipment				
Retirement of Equipment				
in Other Assets				
Changes in Non Current Liabilities and Equity				
in Long Term debt				
in Deferred Income Taxes				
Proceeds from Sale of Stock				
Dividends Paid				
Net Cash Flows				
Net Increase <Decrease> in Cash				

Investing	Activities	Financing	Activities		
Inflow	Outflow	Inflow	Outflow		

DIRECT METHOD

Date	Prepared By	Work Paper No
	Reviewed By	

DEF Company

.064 Gross Cash Flows from Operating Activities (A)

12/31/X5

From Assembly Sheets for Reported Balance Sheet and Cash Flows Worksheet

WP Refs.			
	Cash Received from Customers:		
	Net Sales		1000
	<Increase> Decrease in Accounts Receivable		<100>
	Cash Received from Customers		900
	Cash Paid to Suppliers and Employees:		
	Cost of Sales		500
	Increase <Decrease> in Inventory		50
	<Increase> Decrease in Accounts Payable		<10>
	Cash Paid to Suppliers For Inventory		540
	Research and Development		20
	Selling, General and Administrative Expenses		80
	Other Expense		10
	Increase <Decrease> in Prepaid expenses and		
F	Other Current Assets *	(B)	5
	Increase <Decrease> in Other Assets		5
P	<Increase> Decrease in Accrued Expenses *	(C)	<10>
	<Increase> Decrease in Other Current Liabilities		<5>
			645
	Less: Non Cash Expenses - Depreciation		<60>
	Cash Paid to Suppliers and Employees		<585>
	Dividends Received:		
	Dividend Income		20
	<Increase> Decrease in Dividends Receivable	(B+1)	
	Dividends Received		20
	Interest Paid:		
	Interest Expense		10
	<Increase> Decrease in Accrued Interest	(C+1)	
	Interest Paid		10
	Income Taxes Paid:		
	Provision for Income Taxes		200
	<Increase> Decrease in Income Taxes Payable		<10>
	<Increase> Decrease in deferred Taxes - Current		<10>
	<Increase> Decrease in deferred Taxes - Non Current		<20>
	Income Taxes Paid		160

DEF Company
Gross Cash Flows Worksheet—Notes
12/31/X5

Notes:

(A) This working paper is used to illustrate a method of indirectly determining cash received from customers and cash paid to suppliers and employers for use in a statement of cash flows under the direct method.

(B) This amount would normally include accrued dividends receivable. The amount of accrued dividends would be deducted and reflected at (B-1). For the purpose of simplicity, this illustration assumes that there are no beginning or ending balances in accrued dividends receivable.

(C) This amount would normally include accrued interest payable. The amount of accrued interest would be deducted and reflected at (C-1). For the purpose of simplicity, this illustration assumes that there are no beginning or ending balances in accrued interest receivable.

DIRECT METHOD

Date	Prepared By	Work Paper No
	Reviewed By	

.065 Gross Cash Flows from Operating Activities

From Assembly Sheets for Reported Balance Sheet and Cash Flows Worksheet

WP Refs.

Cash Received from Customers:
Net Sales
<Increase> Decrease in Accounts Receivable
Cash Received from Customers

Cash Paid to Suppliers and Employees:
Cost of Sales
Increase <Decrease> in Inventory
<Increase> Decrease in Accounts Payable
Cash Paid to Suppliers For Inventory

Research and Development
Selling, General and Administrative Expenses
Other Expense
Increase <Decrease> in Prepaid expenses and
P Other Current Assets *
Increase <Decrease> in Other Assets
P <Increase> Decrease in Accrued Expenses *
<Increase> Decrease in Other Current Liabilities

Less: Non Cash Expenses - Depreciation
Cash Paid to Suppliers and Employees

Dividends Received:
Dividend Income
<Increase> Decrease in Dividends Receivable
Dividends Received

Interest Paid:
Interest Expense
<Increase> Decrease in Accrued Interest
Interest Paid

Income Taxes Paid:
Provision for Income Taxes
<Increase> Decrease in Income Taxes Payable
<Increase> Decrease in Deferred Taxes - Current
<Increase> Decrease in Deferred Taxes - Non Current
Income Taxes Paid

.070

ABC Co.
Adjusting Journal Entries
12/31/X5

W.P. Ref.		Client's acct. no.	Dr.	Cr.
	1			
	Provision for doubtful accts	xxxx	xxxx P	
D-1	Allowance for doubtful accounts	xxxx		xxxx P
	To provide an allowance for the balance of xxxx due from Zxywvts Ind. which disclosed its intent to file under Chapter 11 on 12/27/X5			
	2			
	Cost of sales	xxxx	xxxx P	
E-3	Inventory - supplies	xxxx		xxxx P
	To adjust supplies inventory at Plant B to xxxxx per the 12/31/X5 physical.			

P = Traced to client's posting of general ledger.

NOTE:

Adjustments affect the client's accounts and are the client's entries. Their explanations should offer a reader enough information to know why the entry is needed. To merely say "adjust balance to actual" or "per working paper page xx" is not enough.

[The next page is 6527.]

.080

ABC Company
Reclassification Entries
12/31/X5

	Initials	Date
Prepared by		
Approved by		

	Workpaper Reference	Dr.	Cr.
A			
Long-Term Debt	S	xxxxx	
Current Portion of Long-Term Debt	S		xxxxx
To reclassify the portion of long-term debt due within one year to current portion for statement purposes			
B			
Accounts Receivable	C	xxxx	
Accounts Payable	O		xxxx
To reclassify credit balances in accounts receivable to accounts payable for statement purposes			

NOTE:

These entries are made for classification purposes within an individual financial statement and do not affect earnings. Normally, they do not affect the client's accounts and are made only for reporting purposes. However, their explanations should offer a reader enough information to understand why the entry is needed. For information purposes, it may be helpful to provide the client with a copy of the reclassification entries.

.090

ABC Co.
Potential Adjustments
12/31/X5

	Initials	Date
Prepared By		
Approved By		

W.P. Refs. (1)	(2)–(5)	(4)	Dr. (Cr.) (6)	P&L Eff. increase (decrease) (7)	Disposition (8)
			(A)	(B)	AJE 1
	Provision for doubtful accts.		10000	(10000)	(10000)
	Allowance for doubtful accts.		(10000)		
C-5	Re bal of xxx due from Zxywvts Ind.				
D-1	announced intent of bankruptcy				
	12/27/X5.				
					AJE 2
	Cost of sales		10000	(10000)	(10000)
	Inventory - supplies		(10000)		
E-1 E-5	To adjust books to 12/31/X5 physical				
	of supplies inventory at plant B.				
O-4 O-4	SG&A		500	(500)	Waived as
	Accts. payable		(500)		immaterial
	Unrecorded liabilities re:				
	Phone	300			
	Electric	200			
	Total P&L effect of potential adj.			(20500)	
	Less, total effect of adjusting				
	journal entries (AJEs)			(20000)	(20000)
	P&L Effect of total items waived			(500)	
	Less = Estimated effect of income taxes on				
	waived items and AJEs			200 (C)	8000 (C)
	P&L effect net of income taxes			(300)	(12000)
	Net income per financial statements-unadj.				72000
	-final as adjusted				60000
	Waived items net of tax (300) as percent of final				
	net income 00.5% (D)				
	Approved (signature of audit partner) Date (Completion of field work)				

(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)

NOTES:

(A) In this example, debits and credits are grouped in one column and should foot to zero. This was done merely to save space. An auditor may prefer to use separate columns for debits, credits and effect on income. There are many approaches for accumulating potential entries. For example, see the illustrative working paper for accumulating potential adjustments and reclassifications; it provides for accumulation of the effect of potential entries on the balance sheet as well as the income statement.

(B) This column provides for identification of the cumulative effect (which may be material) of a series of relatively immaterial items which are biased in one direction.

(C) For this illustration, the client's effective income tax rate is assumed to be 40%.

(D) The resulting percent is arbitrarily selected solely for demonstrating arithmetic in this illustration.

.091 *Potential Adjustments*

	Initials	Date
Prepared By		
Approved By		

(1) W.P. Refs.	(2)	(3)	(4)	(5)	(6) Dr. (Cr.)	(7) P&L Eff. increase (decrease)	(8) Disposition

Total P&L effect of potential adj.
Less, total effect of adjusting journal entries (AJEs)
P&L Effect of total items waived

Less - Estimated effect of income taxes on waived items and AJEs
P&L effect net of income taxes
Net income per financial statements-unadj.
-final as adjusted

Waived items net of tax (300) as percent of final net income 00.5% (D)

Approved (signature of audit partner) Date (Completion of field work)

(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)

.100

XYZ Corp.
Potential Adjustments and Reclassifications
3/31/X2

	Initials	Date
Prepared By		
Approved By		

(1) W.P. Ref.	(2)–(4)	(5)	(6) Dr.	(7) Cr.	(8) Eff. on net inc. inc (dec)
B/S, P&L	Per financial statements-unadjusted				xxxxx
	①				
J-8	Leased equipment, capitalized		xxxxx(a)		
J-8	Depreciation expense		xxxx(b)		(xxxx)
T-2	Interest expense		xxxx(c)		(xxxx)
T-1	Capitalized lease obligation			xxxxx	
J-8	Accumulated depreciation			xxxx(b)	
	Equipment rental expense			xxxx(c)	xxxx
	To capitalize loader under lease dated 10/15/X1 for period 11/1/X1-10/31/X6, recognize related depreciation and interest expense, and correct client's entry recording payments of xxxx as rental expense, memo info=				
	Total rentals per lease	xxxxx	Orig prin	xxxxx(a)	
	Fair val. of loader	xxxxx(a)	Pmts	xxx(c)	
	Interest element	xxxxx	3/31/X2 bal	xxxxx	
	②				
T-1	Capital lease obligation		xxxx		
	Current portion-cap-lease oblig.			xxxx	
	To segregate current portion of capitalized lease obligation-				
	③				
	Travel expense		xxx		(xxx)
	Advance to employees			xxx	
	Per results of confirmation of advances as of 3/31/X2. As of 3/31/X1, same sort of adjustment for $YYY waived as immaterial				
	Cumulative effect of potential entries				(xxxx)
	Less, cumulative effect of items waived				xxx Ø
	Effect of AJEs & RJEs before inc. taxes				(xxxx)
	Estimated income tax effect				xxxx
	Net effect on financial statements				(xxxx)
	Per financial statements, as adjusted				xxxxx

Ø-Waived items net of inc. tax=X% of final net income
(a)(b)(c)=Cross references only

NOTE:
This expanded working paper format allows for accumulating the effect of potential entries on working capital as well as P&L.

(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
Balance sheet effect, increase (decrease)						Remarks & disposition	
Assets		Liabilities					
Current	Non cur.	Current	Non cur.	Cap stock & pd. in	Accum earnings		
xxxxxx	xxxxxx	xxxxx	xxxxxx	xxxxxx	xxxxxx		
	xxxxx(a)					AJE (1) see (a)	
					(xxxx)	AJE (2) see (b)	
					(xxxx)(c)	AJE (3) see (c)	
			xxxxx(c)				
	(xxxx)(b)					Split into 3 AJEs	
					xxxx(c)		
						(1) To capitalize lease	
						(2) To prov. depcn	
						(3) To correct client's JE re rental exps.	
		xxxx				RJE (1)	
			(xxxx)				
(xxx)					(xxx)	Item waived as immaterial	
(xxx)	xxxxx	xxxx	xxxxx		(xxxx)		
xxx					xxx		
-	xxxxx	xxxx	xxxxx		(xxxx)		
		(xxxx)			xxxx		
-	xxxxx	xxxx	xxxxx		(xxxx)		
xxxxxx	xxxxxx	xxxxx	xxxxxx	xxxxxx	xxxxxx		

Approved (signature of audit partner) Date (completion of field work)

.101 *Potential Adjustments and Reclassifications*

	Initials	Date
Prepared By		
Approved By		

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
W.P. Ref.					Dr.	Cr.	Eff. on net inc. inc(dec)
B/S. P&L	Per financial statements-unadjusted						
	Cumulative effect of potential entries						
	Less, cumulative effect of items waived						
	Effect of AJEs & RJEs before inc. taxes						
	Estimated income tax effect						
	Net effect on financial statements						
	Per financial statements, as adjusted						

(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
Balance sheet effect, increase (decrease)						Remarks & disposition	
Assets		Liabilities		Cap stock & pd. in	Accum earnings		
Current	Non cur.	Current	Non cur.				

Approved

Date

.110

ABC Co.
Working Trial Balance
12/31/X5

	Initials	Date
Prepared By		
Approved By		

(1) Account Number	(2)	(3) Account Title	(4)	(5)	(6) Final 12/31/X4 Grouped for rep.	(7) Final 12/31/X4 Account balances	(8) Per books 12/31/X5

ABC Co.
Alternate Format-Working Trial Balance
12/31/X5

Final 12/31/X4 Grouped for report	Reclass & grouping entries	Final account balances	Account title	Account number	Per books 12/31/X5

NOTES:

This illustration is an alternative to the assembly sheets and lead sheets previously shown. It is a format that may be useful if the client's individual accounts are in a sequence that allows easy grouping into the statement classifications. The form should also offer enough space for symbols and notations of work done, cross references, and a clear identification of the statement groupings. If the client's trial balance is sequenced for easy grouping into statement classifications, pasting a copy of the trial balance onto formats similar to these illustrations may save preparation time.

Proponents of this alternative format believe that preparation of lead sheets requires excessive time and duplicates information on the working trial balance. Proponents of the lead sheet approach argue that benefits such as the following more than justify the preparation time:

- Lead sheets assemble working papers into groups that aid the review process and help staff see detail work in the context of the statements.
- Comparative features of lead sheets aid in performing analytical procedures.
- Lead sheets offer a structure for delegating portions of the work to staff.

(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
Adjusting Journal Entries		Final	12/31/X5 Grouping	Reclassifications		Final for report	Working paper
Dr.	Cr.	12/31/X5	for rep.	Dr.	Cr.		ref.

Adjustments		Final	Grouping and Reclassifications		Final for report	Working paper
Dr.	Cr.	12/31/X5	Dr.	Cr.	12/31/X5	ref.

<u>NOTES</u>:
<u>(continued)</u>

- Lead sheets help avoid a cluttered "top summary" and thereby minimize the potential for clerical error.

The choice of format is the auditor's and should be based on his judgment about the most efficient way to structure the working papers for a particular engagement.

.111

Working Trial Balance

Initials	Date
Prepared By	
Approved By	

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Account Number	Account Title				Final: Grouped for rep.	Final: Account balances	Per books

Alternate Format-Working Trial Balance

Final: Grouped for report	Reclass & grouping entries	Final account balances	Account title			Account number	Per books

(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
Adjusting Journal Entries		Final	Grouping for rep.	Reclassifications		Final for report	Working paper ref.
Dr.	Cr.			Dr.	Cr.		

Adjustments		Final	Grouping and Reclassifications		Final for report	Working paper ref.
Dr.	Cr.		Dr.	Cr.		

ABC Co.

.120 Tax Return Worksheet - Reconciliation to Reported P&L (B)

12/31/X5

	Initials	Date
Prepared By		
Approved By		

(1)–(4) Per Tax Return: Line Ref.	Classification	(5) Amount for rtn	(6) Schedule Increase	(7) M-1 Adjs Decrease	(8) Reported NI in rtn format
1	Gross sales				
	Less, returns & allowances				
	Net sales				
2	Cost of goods sold				
3	Gross profit				
4	Dividends				
5	Interest - obligations of U.S.				
6	Interest - other				
7	Gross rents				
8	Gross royalties				
9	(a) Capital gain				
	(b) Net gain or loss Form 4797				
10	Other income				
11	TOTAL INCOME				
12	Compensation of officers				
13	Salaries & wages				
14	Repairs				
15	Bad debts				
16	Rents				
17	Taxes				
18	Interest				
19	Contributions				
20	Amortization				
21	Depreciation				
22	Depletion				
23	Advertising				
24	Pension & profit sharing				
25	Employee benefit plans				
26	Other deductions				
27	TOTAL DEDUCTIONS				
28	TAXABLE INCOME				

(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
←	Classifications per reported income statement (A)					→	
Net sales	Cost of sales	R&D Exp.	SG&A Exp.	Interest Exp.	Other	Prov. for Inc. Tax	

NOTES:

(A) This sample working paper reconciles the amounts per line items on the return with the reported income statement, and where necessary, directly to the source working papers. All schedule M-1 items should also be explained on this page or an attached set of supporting pages, and referenced to the supporting working papers. In some situations, it may be necessary to prepare this type of schedule in further detail than that of the reported statement of income (or loss).

(B) Some auditors believe that this type of reconciliation should be prepared for all tax returns unless they are easily grouped from the trial balance or financial statements.

Initials	Date
Prepared By	
Approved By	

.121 Tax Return Worksheet - Reconciliation to Reported P&L

Per Tax Return: Line Ref.	Per Tax Return: Classification	Amount for rtn	Schedule M-1 Adjs: Increase	Schedule M-1 Adjs: Decrease	Reported NI in rtn format
1	Gross sales				
	Less, returns & allowances				
	Net sales				
2	Cost of goods sold				
3	Gross profit				
4	Dividends				
5	Interest - obligations of U.S.				
6	Interest - other				
7	Gross rents				
8	Gross royalties				
9	(a) Capital gain				
	(b) Net gain or loss Form 4797				
10	Other income				
11	TOTAL INCOME				
12	Compensation of officers				
13	Salaries & wages				
14	Repairs				
15	Bad debts				
16	Rents				
17	Taxes				
18	Interest				
19	Contributions				
20	Amortization				
21	Depreciation				
22	Depletion				
23	Advertising				
24	Pension & profit sharing				
25	Employee benefit plans				
26	Other deductions				
27	TOTAL DEDUCTIONS				
28	TAXABLE INCOME				

(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
← Classifications per reported income statement (A) →							
Net sales	Cost of sales	R&D Exp.	SG&A Exp.	Interest Exp.	Other	Prov. for Inc. Tax	

.130

ABC Company
Confirmation Control Sheet
12/31/X5

	Initials	Date
Prepared By		
Approved By		

Description Addressee	(1) Dates of First request	(2) Second request	(3) Additional requests	(4) Response received	(5) W.P. Ref of response
Client's rep					
Attorneys letters John Doe, Esq.					
Brown & Jones					
Bank confirmations See attached list					
A/C Receivable See attached copies					
Other descriptions and addresses such as custodians of marketable securities					
and holders or trustees of long-term debt would be entered similar to the above.					

NOTE:

(A) Some auditors prepare this type of control sheet to include all confirmations and representations requested. Others prepare it for the client's representation and attorneys letters and use tissue copies as the control for other requests until routine prompt responses have cleared. Then the addressees who have not responded promptly would be entered on this control sheet for special attention.

.140

ABC Company

Materials to be Prepared by Client

12/31/X5

	Initials	Date
Prepared By		
Approved By		

Description	(1)	(2)	(3) Date promised	(4) Date received	(5) Effect on time? (Yes/No)
Working trial balance					
Bank reconciliations - 12/31 (copies)					
Standard bank confirms					
Accts. receivable - schedule of balances written off					
Accts. receivable - aged trial balance					
Inventory - copy of physical, priced, extended and summarized					
Inventory - standard cost work-up					
Prepaid insurance - analysis					
Property taxes analysed					
Property, plant & equipment					
Additions schedule					
Retirements schedule					
Analysis of asset accounts					
Analysis of accumulated depreciation					
Accounts payable listing					
Maintenance and repair expense					

NOTE:

(A) The above materials are illustrative only, and in no way meant to be a comprehensive example of what materials may be prepared by clients.

.150

ABC Co.
Lead Schedule (Sheet) - General Example
12/31/X5

	Initials	Date
Prepared By		
Approved By		

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
			12/31/X4	12/31/X5			
Client's A/C Code	Account Title		Final Bal	Bal per Client	Adj. Dr. (Cr.)	Final Bal	W.P. Ref.

NOTES:

(A) This type of schedule may be prepared for any caption in the financial statements to show a comparative grouping of individual accounts, aid in performing analytical procedures at a detailed level, and provide a trail between the financial statement classifications, the client's accounts, and the detailed papers concerning the work done.

(B) Lead schedules may also include the preparer's conclusion on the results of the work done and notations on such matters as relationship with other accounts, and proposed adjustments, reclassifications and disclosure requirements. Some firms require that the lead sheet include the auditor's individual conclusions on the audit objectives, work done and resulting findings.

(C) This schedule can readily be modified to allow for two columns for adjustments, additional space for the account title, and additional columns for remarks.

.151 Lead Schedule (Sheet) - General Example

	Initials	Date
Prepared By		
Approved By		

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Client's A/C Code	Account Title		Final Bal	Bal per Client	Adj. Dr. (Cr.)	Final Bal	W.P. Ref.

.160

ABC Company
Cash - Lead Sheet
12/31/X5

	Initials	Date
Prepared By		
Approved By		

Work paper Reference	Description					Account Number	Final Balance 12/31/X4
A-1	Petty Cash (A)						
A-2	Fifth National Bank (A)						
A-3	Sixth National Bank (B)						
A-4	Ninth State Bank - payroll A/C (B)						
A-5	Uptown Bank & Trust Co. (B)						
A-6	Downtown Bank & Trust Co. (B)						
A-7	Standard bank confirms A-7-1 (A) (B)						
A-8	Symbol legend - bank reconciliations (A) (C)						
A-9	Bank transfer schedule (A)						

NOTES:

(A) Illustrative working papers are present for pages A-1 A-2 A-7-1 A-8 and A-9 behind lead sheet.

(B) Illustrations are not present for pages A-3 A-4 A-5 A-6 A-7-2 A-7-3 A-7-4 and A-7-5.

(C) This symbol legend is located behind the reconciliation because the legend is on columns 9-16 of a 16-column spread sheet. This allows a reviewer to fold out the legend and see it as he looks at each reconciliation filed in front of it. If the papers are bound at the top of the page, and individual worksheets are spread to the right such as on 16-column paper, the legend may be set up so it folds out to the left. Then a reviewer can still see the legend as he looks at individual spread sheets.

A

(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)	
Per Books 12/31/X5	Adjusting Journal Entries Dr.	Cr.	Adjusted Balance 12/31/X5	Reclassification Entries Dr.	Cr.	Final Balance 12/31/X5		
								1
								2
								3
								4
								5
								6
								7
								8
								9
								10
								11
								12
								13
								14
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								31
								32
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								38
								39
								40

	Initials	Date
Prepared By		
Approved By		

.161 Cash - Lead Sheet

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Work paper Reference	Description					Account Number	Final Balance

(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
Per Books	Adjusting Journal Entries Dr.	Cr.	Adjusted Balance	Reclassification Entries Dr.	Cr.	Final Balance	

.170

ABC Company
Petty Cash Count
12/31/X5

	Initials	Date
Prepared By		
Approved By		

	(1)	(2)	(3) Wrapped	(4) Loose	(5) Total
Currency:					
$100.00					
50.00					
20.00					
10.00					
5.00					
1.00					
Coin:					
1.00					
.50					
.25					
.10					
.05					
.01					
Vouchers, Undeposited Checks, etc. (describe):					
Less-Receipts Subsequent to Cut-off (describe):					
Amount of Fund-As Counted					
(Overage)-Shortage					
Amount of Fund-Per Books					

Receipt

The above detailed items were counted in my presence and returned to me intact by (insert individual's name), representative of [insert auditor's firm name].

Date and Time________________ ________________________

Signature of Custodian

Cut-off Information: Last Recpt. No. Last Check No.

.171 Petty Cash Count

	Initials	Date
Prepared By		
Approved By		

	(1)	(2)	(3) Wrapped	(4) Loose	(5) Total
Currency:					
$100.00					
50.00					
20.00					
10.00					
5.00					
1.00					
Coin:					
1.00					
.50					
.25					
.10					
.05					
.01					
Vouchers, Undeposited Checks, etc. (describe):					
Less-Receipts Subsequent to Cut-off (describe):					
Amount of Fund-As Counted					
(Overage)-Shortage					
Amount of Fund-Per Books					

<u>Receipt</u>

The above detailed items were counted in my presence and returned to me intact by [insert individual's name], representative of [insert auditor's firm name].

Date and Time____________ ____________________

Signature of Custodian

Cut-off Information	Last Recpt. No.	Last Check No.

ABC Company
Bank Reconciliation - Fifth National Bank
12/31/X5

	Initials	Date
Prepared By		
Approved By		

	(5)	(6)	(7)	(8)
Balance per Bank				xxxxx C
Add-Deposits in Transit				
	Date per Client	Date per Bank		
	12/30	1/02	xxxx T	
	12/30	1/02	xxxx T	
	12/31	1/04	xxxx T	
				xxxxx
Less - Checks Outstanding				
	Check #	Date		
	988	12/10	xxx ч	
	995	12/24	xxx ч	
	1001	12/27	xxx ч	
	1008	12/31	xxx √	
	1009	12/31	xxxxx ч A-9	
	1010	12/31	xxxxx ч A-9	
			xxxxx	xxxx
Other Reconciling items				--
Balance per Books 12/31/X5				xxx
				G/L T/B A

See symbol legend pg A-8

A-2

.181 Bank Reconciliation

	Initials	Date
Prepared By		
Approved By		

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Balance per Bank							
Add-Deposits in Transit							
				Date per			
				Client	Bank		
Less - Checks Outstanding							
				Check #	Date		
Other Reconciling items							
Balance per Books							
See symbol legend pg							

[The next page is 6557.]

.190

STANDARD FORM TO CONFIRM ACCOUNT BALANCE INFORMATION WITH FINANCIAL INSTITUTIONS

ORIGINAL
To be mailed to accountant

ABC Company
CUSTOMER NAME

Financial Institution's Name and Address
[ ]
Fifth National Bank
P.O. Box 31428
Downtown, NY 01010-2341
[ ]

We have provided to our accountants the following information as of the close of business on December 31, 19X1, regarding our deposit and loan balances. Please confirm the accuracy of the information, noting any exceptions to the information provided. If the balances have been left blank, please complete this form by furnishing the balance in the appropriate space below.* Although we do not request nor expect you to conduct a comprehensive, detailed search of your records, if during the process of completing this confirmation additional information about other deposit and loan accounts we may have with you comes to your attention, please include such information below. Please use the enclosed envelope to return the form directly to our accountants.

1. At the close of business on the date listed above, our records indicated the following deposit balance(s):

ACCOUNT NAME	ACCOUNT NO.	INTEREST RATE	BALANCE*
ABC Company	7806-8224	5.5%**	$XXXX** A-2

2. We were directly liable to the financial institution for loans at the close of business on the date listed above as follows:

ACCOUNT NO./ DESCRIPTION	BALANCE*	DATE DUE	INTEREST RATE	DATE THROUGH WHICH INTEREST IS PAID	DESCRIPTION OF COLLATERAL
32458-1	$XXXX**	2/15/X5	9.5%	Dec. 15, 19X1	None TO N-1

Kathleen Daye
(Customer's Authorized Signature)

December 20, 19X1
(Date)

The information presented above by the customer is in agreement with our records. Although we have not conducted a comprehensive, detailed search of our records, no other deposit or loan accounts have come to our attention except as noted below.

Joseph Weeks
(Financial Institution Authorized Signature)

January 5, 19X2**
(Date)

Assistant V. P.**
(Title)

EXCEPTIONS AND/OR COMMENTS

None**

Please return this form directly to our accountants:
[ ]
Name of Auditor
Address of Auditor
[ ]

* Ordinarily, balances are intentionally left blank if they are not available at the time the form is prepared.

Approved 1990 by American Bankers Association, American Institute of Certified Public Accountants, and Bank Administration Institute. Additional forms available from: AICPA – Order Department, P.O. Box 1003, NY, NY 10108-1003

D451 5951

**Information input by Bank

Note: The confirmation response should be cross-referenced to all relevant working papers (in this example, to the bank reconciliation [working paper A-2] and notes payable [working paper N-1]). The bank should answer all questions. If some are not answered, the bank should be called or written so the missing information can be obtained (in writing).

.200

ABC Company

Cash - Symbol Legend for Bank Reconciliations (See Notes)

12/31/X5

	Initials	Date
Prepared By		
Approved By		

NOTES:

(A) This legend is placed behind the reconciliations because it is on the fold-out portion of a 16-column spread sheet. This approach allows the reviewer to unfold the legend and see the symbols as he reviews each reconciliation working paper.

If the papers are fastened at the top and the pages are double with spread sheets that unfold to the right, the legend can be set up so that it unfolds to the left side or bottom of the page. Then a reviewer may still see the legend as he looks at individual spread sheets.

(B) In this example, no exceptions were noted. However, if any were present, a separate symbol and explanation cross-referencing to an exception listing would also be included in this legend.

(C) In this example, it is assumed that based on the auditor's assessment of control risk for relevant assertions, the following steps were performed at a preliminary date and recorded elsewhere in the working papers:

(i) Preparation of proofs of cash to test total activity per the cash receipts and cash disbursements journal.

(ii) Comparison of entries per the cash disbursements journal to paid checks for date, number, payee, amount, and examination of check for proper signature and comparison of endorsement with identification of payee.

(iii) Accounting for all checks issued during a test month as paid, outstanding or void.

(A) = To cash lead sheet

W = Footed, cross-footed

C = Confirmed by bank

T/B = Agreed to working trial balance

G/L = Agreed to general ledgers

T = Deposit in transit traced to Jan. XX, 19X6 cutoff bank statement and cash receipts book for amount and dates indicated, in-transit period appears reasonable.

K = Examined paid check returned with January XX, 19X6 cutoff bank statement; date check number and amount agrees with outstanding check list. Compared date, number, payee and amount per check to cash disbursements journal, found they agreed without exception (B)

V = Outstanding check not returned with bank cutoff statement. Compared date, check number and amount to cash disbursements journal and supporting voucher; compared payee and account distribution per cash disbursements journal to supporting voucher: found voucher properly approved and found items compared in agreement without exception. (B)

[The next page is 6561.]

	Initials	Date
Prepared By		
Approved By		

.201 Cash - Symbol Legend for Bank Reconciliations

A = To cash lead sheet

W = Footed, cross-footed

C = Confirmed by bank

T/B = Agreed to working trial balance

G/L = Agreed to general ledgers

T = Deposit in transit traced to Jan. XX, 19X6 cutoff bank statement and cash receipts book for amount and dates indicated, in-transit period appears reasonable.

N = Examined paid check returned with January XX, 19X6 cutoff bank statement; date check number and amount agrees with outstanding check list. Compared date, number, payee and amount per check to cash disbursements journal, found they agreed without exception

V = Outstanding check not returned with bank cutoff statement. Compared date, check number and amount to cash disbursements journal and supporting voucher; compared payee and account distribution per cash disbursements journal to supporting voucher: found voucher properly approved and found items compared in agreement without exception.

.210

ABC Company
Bank Transfer Schedule
12/31/X5

	Initials	Date
Prepared By		
Approved By		

Reviewed bank statements and cash receipts & disbursement journals from 12/XX/X5 to 1/YY/X6 for bank transfers of $XXX or larger. (A)

Check No.	Bank Accounts From	Bank Accounts To	Amount	Date disbursed per Books (B)	Date disbursed per Bank (C)	Date deposited per Book (B)	Date deposited per Bank (C)
1010	5th Natl.	Downtown	xxxxx	12/31	1/05 A-2	12/31	1/02 T
1009	5th Natl.	9th State	xxxxx	12/31	1/04 A-2	12/31	1/02 T
5440	6th Natl.	Downtown	xxxx	1/03	1/04	1/03	1/06
1040	Uptown	Downtown	xxxx	12/30	1/05 Ø	12/30	1/03 T

Ø - Should be cross-referenced to outstanding checklist of applicable bank reconciliations

T - Should be cross-referenced to deposit in transit per applicable bank reconciliation

NOTES:

(A) The number of days before and after the balance sheet date selected for testing will depend on the auditor's understanding of the internal control structure and assessment of control risk; the use of a minimum dollar amount in selecting transfers also depends on the auditor's judgment concerning materiality.

(B) Receipts and disbursements per books should be recorded in the same month.

(C) Any disbursements with bank statement dates that precede the dates per books should be investigated.

A-9

.211

Bank Transfer Schedule

	Initials	Date
Prepared By		
Approved By		

Reviewed bank statements and cash receipts & disbursement journals from to for bank transfers of $ or larger.

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Check No.	Bank Accounts		Amount	Date disbursed per		Date deposited per	
	From	To		Books (B)	Bank (C)	Book (B)	Bank (C)

.220

ABC Company
Proof of Cash 9/30 - 12/31/X5
12/31/X5

Initials	Date
Prepared By	
Approved By	

(Name of Bank) (Bank A/C Number)	Recon. of balance 9/30/X5	Activity 10/1-12/31 Receipts	Activity 10/1-12/31 Disb.	Recon. of balance 12/31/X5
Balances and activity per bank statements	xxxxx	xxxxx	(xxxxx)	xxxxx
Deposits in transit				
9/30/X5	xxxx	(xxxx)		
12/31/X5		xxxxx		xxxxx
Outstanding checks				
9/30/X5	(xxxx)		xxxx	
12/31/X5			(xxxxx)	(xxxxx)
Other reconciling items				
(Describe)	xxx		(xxx)	
		xxx		xxx
Per books	xxxxx	xxxxx	xxxxx	xxxxx

NOTES:

(A) All columns and lines should foot and cross-foot; and there should be clear indications of the work done.

(B) Some find it helpful to prepare this analysis by (1) first entering the bank reconciliations of the opening and closing balances, (2) then identifying the deposits and disbursements per the bank statements and the client's cash receipts journal and cash disbursements journals, and (3) analyse and complete reconciliation of deposits and disbursements.

(C) See sections 5400.080 and 5400.100--.110, Illustrative Audit Objectives and Audit Procedures.

.221 Proof of Cash

	Initials	Date
Prepared By		
Approved By		

(1) (Name of Bank) (Bank A/C Number)	(2)	(3)	(4) Recon. of balance 9/30/X5	(5) Activity 10/1-12/31 Receipts	(6) Activity 10/1-12/31 Disb.	(7) Recon. of balance 12/31/X5	(8)
Balances and activity per bank statements			xxxxx	xxxxx	(xxxxx)	xxxxx	
Deposits in transit							
9/30/X5			xxxx	(xxxx)			
12/31/X5				xxxxx		xxxxx	
Outstanding checks							
9/30/X5			(xxxx)		xxxx		
12/31/X5					(xxxxx)	(xxxxx)	
Other reconciling items							
(Describe)			xxx		(xxx)		
				xxx		xxx	
Per books			xxxxx	xxxxx	xxxxx	xxxxx	

.222

ABC Co.

Cash - Analytical Procedures

12/31/X5

Date	Prepared By	Work Paper No.
	Reviewed By	

Bank A/C No.	G/L A/C No.	Balance 12/31/X4	Balance 12/31/X5	Change	W/P References - Investigation of Material Changes

.223

Date	Prepared By	Work Paper No
	Reviewed By	

Cash - Analytical Procedures

Bank A/C No.	G/L A/C No.	Balance	Balance	Change	W/P References - Investigation of Material Changes

.230

ABC Company
Marketable Equity Securities, Cost, Market & Gross Unrealized Gains (Losses)

	Initials	Date
Prepared By		
Approved By		

(1) (2) Description	(3) No. of shares	(4) 12/31/X5 Cost	(5) Market value per share	(6) Market value (A) amt	(7) Gross unrealized (A) Gain	(8) Gross unrealized (A) (Loss)
Current						
XYZ Corp 5% cum pfd	xxx	xxxxx	xx	xxxxx	xxxx	
UVW Co. 6% pfd	xxx	xxxx	xx	xxxx		(xxx)
Marx Corp com	xxx	xxxx	xx	xxxx	xxx	
		xxxxx		xxxxx	xxxx	
					(xxx)	(xxx)
Net unrealized gain					xxxx	
Carrying amount 12/31/X5		xxxxx				
Non Current						
Amalgamated Co com	xxxx	xxxxx	xx	xxxxx		(xxxx)
WXY Co. 8% cv pfd	xxxx	xxxxx	xx	xxxxx	xxx	
		xxxxx		xxxxx	xxx	(xxxx)
						xxx
Net unrealized loss		(xxxx)	∅			(xxxx)
Carrying amount 12/31/X5		xxxxx		xxxxx		

∅ Valuation allowance required

NOTE:

(A) The above columns for market value, gross unrealized gains and gross unrealized losses may also be worked into the marketable securities analysis (section 6500.240) if wider analysis paper is available. This would avoid the need to recopy or photocopy the descriptions, numbers of shares and costs for the above.

	Initials	Date
Prepared By		
Approved By		

.231 Marketable Equity Securities, Cost, Market & Gross Unrealized Gains (Losses)

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Description		No. of shares	Cost	Market value per share	amt	Gross unrealized Gain	(Loss)
Current							
Net unrealized							
Carrying amount							
Non Current							
Net unrealized							
Carrying amount							

.240

ABC Company
Marketable Equity Securities - Analysis
12/31/X5

	Initials	Date
Prepared By		
Approved By		

(1) (2)	(3)	(4)	(5)		(6)	(7)		(8)
	12/31/X4 Balance		Additions			Sales and		
Description	Number of Shares	Cost	Date	No. of Shares	Cost	Date	Shares	Cost
Current								
XYZ Corp. 5% Cum Pfd	xxx	xxxxx						
UVW Co. 6% Pfd	xxx	xxxxx				11/30	xxx	xxxx
Boxer Ind com	xxx	xxxx				9/15	xxx	xxxx
Manx Corp com			3/15	xxx	xxxx			
		xxxxx			xxxx			xxxx
Non Current								
Amalgamated Co com	xxxx	xxxxx		xxx	xxxx			
WXY Co. 8% Cv Pfd	xxxx	xxxxx						
		xxxxx			xxxx			

Dividend income - accrued rec - per client
Adjustment - accrued div re WXY Co. 8% Cv Pfd
Final 12/31/X5

NOTES:

(A) The auditor may wish to use wider paper and insert the following additional columns between "12/31/X5 balance at cost" and the columns on dividend income:

- Market value per share
- Market value amount
- Gross unrealized gains
- Gross unrealized losses

(B) The dividend income analysis was included above so the auditor could refer to the timing of additions, sales and dispositions on the same page when checking dividends earned.

(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
Dispositions		12/31/X5	Bal (A)	Dividend Income (B)			
Proceeds	Realized Gain (Loss)	No. of Shares		Accrued 12/31/X4	Earned 19X5	Collected 19X5	Accrued 12/31/X5
		xxx	xxxxx	xxx	xxxx	xxxx	xxx
xxxx	xxx	xxx	xxxx	xxx	xxxx	xxxx	xxx
xxxx	(xxx)			xxx	xxx	xxx	
		xxx	xxxx		xxx	xxx	xxx
xxxx	xxx		xxxxx	xxx	xxxx	xxxx	xxx
		xxxx	xxxxx	xxx	xxxx	xxxx	xxx
		xxxx	xxxxx	xxx	xxxx	xxxx	
			xxxxx	xxx	xxxx	xxxx	xxx
				xxx	xxxx		xxx
					xxx		xxx
					xxxx		xxx

.241 Marketable Equity Securities - Analysis

	Initials	Date
Prepared By		
Approved By		

(1)	(2)	(3)	(4)	(5)		(6)	(7)		(8)
			Balance	Additions					Sales and
Description		Number of Shares	Cost	Date	No. of Shares	Cost	Date	Shares	Cost
Current									
Non Current									

(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
Dispositions			Bal	Dividend Income (B)			
Proceeds	Realized Gain (Loss)	No. of Shares		Accrued	Earned	Collected	Accrued

ABC Company

.250 Marketable Equity Securities - Valuation Allowances

12/31/X5

	Prepared By	Approved By
Initials		
Date		

(1)–(4)	(5) Val allow 12/31/X4	(6) Dr or (Cr) to Net income (A)	(7) Dr or (Cr) to Stkhldrs equity (A)	(8) Val allow 12/31/X5
Current portfolio				
Market valuation	70000 Ø			75000 (B)
Cost	75000 Ø			72000 (B)
Net unrealized gain (loss)	(5000) Ø			3000 (B)
Val. allowance required	5000 Ø	(5000)		0
Non-current portfolio				
Market valuation	82000 Ø			81000 (B)
Cost	80000 Ø			82000 (B)
Net unrealized gain (loss)	2000 Ø			(1000) (B)
Val allowance required	-0- Ø		1000	1000

Ø - Per 12/31/X4 working papers

NOTES:

(A) See Statement of Financial Accounting Standards No. 12, paragraph 11.

(B) This illustration uses summary captions rather than a listing of the individual securities in each portfolio on the assumption that amounts are cross-referenced to the related illustrative working papers on cost, market, & gross unrealized gains (losses); and analysis of balances and activity.

.251 Marketable Equity Securities - Valuation Allowances

	Initials	Date
Prepared By		
Approved By		

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
					Val allow	Dr or (Cr) to Net income	Stkhldrs equity	Val allow
Current portfolio								
Market valuation								
Cost								
Net unrealized gain (loss)								
Val. allowance required								
Non-current portfolio								
Market valuation								
Cost								
Net unrealized gain (loss)								
Val allowance required								
Per working papers								

.252

ABC Co.

Marketable Securities - Analytical Procedures

12/31/X5

Date	Prepared By	Work Paper No
	Reviewed By	

G/L A/C No.		Balance 12/31/X4	Balance 12/31/X5	Differences	W/P Ref Follow Up of Material Differences
	Marketable Securities				
	Allowance - Unrealized Losses				
	Realized Gains				
	Realized Losses				
	Unrealized Losses				
	Dividend Income				

.253

Date	Prepared By	Work Paper No
	Reviewed By	

Marketable Securities - Analytical Procedures

G/L A/C No.		Balance	Balance	Differences	W/P Ref Follow Up of Material Differences
	Marketable Securities				
	Allowance - Unrealized Losses				
	Realized Gains				
	Realized Losses				
	Unrealized Losses				
	Dividend Income				

.260

ABC Company
Notes Receivable
12/31/X5

	Initials	Date
Prepared By		
Approved By		

(1)	(2)	(3)		(4)	(5)	(6)	(7)	(8)
Maker (Endorser)		Date Made	Due	Original amount	Terms of repayment	Collateral		Interest rate

NOTE:

(A) This analysis, with some minor modification (provision for market valuations, and analysis of premium or discount) may also be used for investments in marketable debt securities.

(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
Principal				Related Interest			
Balance 12/31/X4	Additions	Payments	Balance 12/31/X5	Accr Rec 12/31/X4	Earned 19X5	Rec'd 19/X5	Accr Rec 12/31/X5

.261 Notes Receivable

	Initials	Date
Prepared By		
Approved By		

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Maker (Endorser)		Date Made Due	Original amount	Terms of repayment	Collateral		Interest rate

(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
	Principal				Related	Interest	
Balance	Additions	Payments	Balance	Accr Rec	Earned	Rec'd	Accr Rec

.262

ABC Co.

Notes Receivable - Analytical Procedures

12/31/X5

Date	Prepared By	Work Paper No.
	Reviewed By	

G/L A/C No.		Balance 12/31/X4	Balance 12/31/X5	Difference	W/P Ref Follow Up Of Material Differences
	Notes Receivable				
	Interest Income				
Ratio Analysis:		19X4	19X5		
Interest Earned					
Average Notes Outstanding					

Date	Prepared By	Work Paper No
	Reviewed By	

.263 Notes Receivable - Analytical Procedures

G/L A/C No.		Balance 12/31/X4	Balance 12/31/X5	Difference	W/P Ref Follow Up Of Material Differences
	Notes Receivable				
	Interest Income				

Ratio Analysis:

$$\frac{\text{Interest Earned}}{\text{Average Notes Outstanding}}$$

.270

ABC Company

Accounts Receivable - Lead Sheet
12/31/X5

	Initials	Date
Prepared By		
Approved By		

Work paper ref	Account titles	Client's acct. no.	Final Bal. 12/31/X4
	Trade accounts receivable, gross		
	Less allowances for		
	- Discounts		
	- Credits		
	subtotal		
	Less, allowance for doubtful accts.		
	Trade receivables, net		
	Other receivables:		
	(Describe individual accounts, if more practical, list them on a separate sheet as either page two of this lead sheet or as a separate lead sheet with a separate grouping of working papers)		
	Relationships - Sales and trade receivables		
	Gross sales,		
	Less: discounts		
	allowances		
	Net sales		
	Less: cash sales		
	Net account sales		
	Turnover ratios		

(9) Per client 12/31/X5	(10) A.J.Es Dr	(11) A.J.Es Cr	(12) Balance as adjusted 12/31/X5	(13)	(14) Remarks	(15)	(16)

NOTES:

(A) This format may be expanded to show columns for reclassification entries.

(B) The account titles and other captions on this work sheet are also merely illustrative. Actual titles will depend on the circumstances of the engagement and the needs and preferences of the auditor.

.271 Accounts Receivable - Lead Sheet

	Initials	Date
Prepared By		
Approved By		

(1) Work paper ref	(2)	(3) Account titles	(4)	(5)	(6)	(7) Client's acct. no.	(8) Final Bal.
	Trade accounts receivable, gross						
	Less allowances for						
	- Discounts						
	- Credits						
	subtotal						
	Less, allowance for doubtful accts.						
	Trade receivables, net						
	Other receivables:						
	(Describe individual accounts, if more practical, list them on a separate sheet as either page two of this lead sheet or as a separate lead sheet with a separate grouping of working papers)						
	Relationships - Sales and trade receivables						
	Gross sales,						
	Less: discounts						
	allowances						
	Net sales						
	Less: cash sales						
	Net account sales						
	Turnover ratios						

(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
Per client	A.J.Es		Balance as adjusted		Remarks		
	Dr	Cr					

ABC Co.

.280 Accts. Receivable - Confirm Statistics

12/31/X5

	Initials	Date
Prepared By		
Approved By		

	Number of Accounts		Dollars	
	Count	Percent	Amount	Percent
Confirm requests				
Positives				
Negatives				
Total sent				
Accts picked-client asked us not to confirm (A) (B)				
Total picked for testing	xxx(D)	yy(D)	xxxxxx(D)	zz(D)
Total accts rec at (insert confirm date)	aaaaaa	100%	aaaaaa	100%
RESULTS - replies received through (insert date)				
Positives - no exception				
Negatives - did not reply or reported no exceptions				
Differences reported & resolved as no exceptions				
Positive				
Negative				
Totals confirmed				
Unanswered positives and accts client asked us not to confirm (B)				
Total confirmed & tested				
Differences found to be potential adjustments				
Positive replies				
Negative replies				
Total (C)				
Totals selected for testing	xxx(D)	yy(D)	xxxxxx(D)	zz(D)

(A) See W.P. (ref_____) on accts client asked us not to confirm & disposition.

(B) See W.P. (ref_____) on alt means procedures and results.

(C) See W.P. (ref_____) on conclusions reached and proposed disp.

(D) These two lines present identical data for balancing purposes.

NOTE:

(A) Comparative summaries of confirmation results in carryforward working papers may be informative and useful.

.281 Accts. Receivable - Confirm Statistics

	Initials	Date
Prepared By		
Approved By		

	Number of Accounts		Dollars	
	Count	Percent	Amount	Percent
Confirm requests				
Positives				
Negatives				
Total sent				
Accts picked-client asked us not to confirm (A) (B)				
Total picked for testing				
Total accts rec at (insert confirm date)				
RESULTS - replies received through (insert date)				
Positives - no exception				
Negatives - did not reply or reported no exceptions				
Differences reported & resolved as no exceptions				
Positive				
Negative				
Totals confirmed				
Unanswered positives and accts client asked us not to confirm (B)				
Total confirmed & tested				
Differences found to be potential adjustments				
Positive replies				
Negative replies				
Total (C)				
Totals selected for testing				

(A) See W.P. (ref_____) on accts client asked us not to confirm & disposition.

(B) See W.P. (ref_____) on alt means procedures and results.

(C) See W.P. (ref_____) on conclusions reached and proposed disp.

.290

ABC Company
Accts Receivable - Reconciliation from Confirmation Date to Year End

	Initials	Date
Prepared By		
Approved By		

12/31/X5

	(6)	(7)	(8)
Balance 11/30/X5, confirm date		xxxxxx	(A)
Add: Sales	xxxxxx		
Other (describe if any):	xxxx(D)		
	xxxx		
		xxxxxx	
		xxxxxx	
Deduct: Cash receipts	xxxxxx(B)		
Credit memos	xxxxx(C)		
Other (describe if any):	xxxx(D)		
	xxxx		
		xxxxxx	
Balance per books 12/31/X5		xxxxxx	
Adjustments (describe if any):			
Final balance		xxxxxx	

NOTES:

(A) Should be cross-referenced to working paper summarizing or scheduling total of subsidiary detail used for confirmation selections.

(B) Should be traced to source, such as sales journal and cash receipts journal.

(C) Depending on the circumstances, it may be necessary to segregate by such types of credits as adjustments of selling prices and returns of shipments.

(D) There are various possibilities. For example, the client may make adjustments based on the auditor's findings during preliminary work, or adjustments to resolve certain differences disclosed by the confirmation procedures.

.291 Accts Receivable - Reconciliation from Confirmation Date to Year End

	Initials	Date
Prepared By		
Approved By		

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Balance 11/30/X5, confirm date								
Add:	Sales							
	Other (describe if any)					)		
Deduct:	Cash receipts					)		
	Credit memos					)		
	Other (describe if any)					)		
Balance per books 12/31/X5								
Adjustments (describe if any):								
	Final balance							

.300

ABC Co.
Accts. Rec. - Review of Post Bal. Sheet Cr. Memos
12/31/X5

	Initials	Date
Prepared By		
Approved By		

Name of Customer	Credit Memo Date	Credit Memo No.	Amount	Description

NOTE:

(A) Reviewed sales journal for 1/1/X6 through (indicate date) and examined all credit memos of $XXX and over. Also reviewed file of unposted memoranda on (indicate date) and examined all credit memos of $XXX and over.

.301 *Accts. Rec. - Review of Post Bal. Sheet Cr. Memos*

	Initials	Date
Prepared By		
Approved By		

Name of Customer	Credit Memo Date	No.	Amount	Description	

NOTE:

Reviewed sales journal for through and examined all credit memos of and over. Also reviewed file of unposted memoranda on (indicate date) and examined all credit memos of and over.

ABC Company
Confirmation Control Sheet (A)
12/31/X5

	Initials	Date
Prepared By		
Approved By		

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
				1st Request		2nd Request	
Confirm. Control No.	Name of Company			Date Sent	Date Received	Date Sent	Date Received

NOTE:

(A) There are various approaches to controlling confirmation procedures. Some auditors may use copies of the confirmation letters to control positive confirmation requests and use a symbol and legend on a schedule, tape or aging analysis to indicate balances selected for confirmation and the type of response received.

.311

Confirmation Control Sheet

	Initials	Date
Prepared By		
Approved By		

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	Confirm. Control No.	Name of Company			1st Request		2nd Request	
					Date Sent	Date Received	Date Sent	Date Received
1								
2								
3								
4								
5								
6								
7								
8								
9								
10								
11								
12								
13								
14								
15								
16								
17								
18								
19								
20								
21								
22								
23								
24								
25								
26								
27								
28								
29								
30								
31								
32								
33								
34								
35								
36								
37								
38								
39								
40								

.320

ABC Company
Accts. Receivable - Aging Analysis (A)
12/31/X5

	Initials	Date
Prepared By		
Approved By		

Name of customer (B)	Total bal per sub. ledger	Current 1-30 days	Past Due 31-60 days	Past Due 61-90 days	Past Due Over 90 days
(1) (2) (3)	(4)	(5)	(6)	(7)	(8)
Aging Analysis Totals (B)					
Percentage analysis of aging	100%	xx%	xx%	xx%	xx%

NOTES:

(A) This analysis is often prepared by clients for internal purposes. If practical, the auditor may save time by using a copy of the client's schedule for working paper purposes. The auditor may need to modify his (her) copy of the client's schedule by adding additional columns or pasting the copy on to a format similar to this illustration.

(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
Remarks				Allowance needed (C)			
				Explanation			Amount

NOTES (continued)

(B) Depending on the circumstances (internal control structure, relative number of customer accounts and significance of individual balances) the auditor may include any of the following in the working papers:

(i) copy of the complete aging analysis;
(ii) detail aging analysis of only those customer accounts with balances over a predetermined dollar amount and summary amounts for aging of accounts with balances equal to and lesser than the predetermined amount.
(iii) summary of the aging analysis totals and other schedules and narratives to describe detail testing.

(C) These columns are used when individual customer balances may be large enough in relation to the total receivables balance for review on a specific account basis to determine the need for allowances.

.321 Accts. Receivable - Aging Analysis

	Initials	Date
Prepared By		
Approved By		

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
					Past Due		
Name of customer			Total bal per sub. ledger	Current 1-30 days	31-60 days	61-90 days	Over 90 days
Aging Analysis Totals							
Percentage analysis of aging			%	%	%	%	%

(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
Remarks				Allowance needed			
				Explanation			Amount

ABC Company
Accounts Receivable - Other
12/31/X5

	Initials	Date
Prepared By		
Approved By		

(1) (2) Due from	(3) (4) Explanation	(5) Final bals. 12/31/X4	(6) Balances 12/31/X5 Per client	(7) AJEs Dr (Cr)	(8) Final
		(A)	(A)		
Describe individual components deemed significant enough for application of auditing procedures.					
	Subtotal				
Other (B)					
Total					

NOTES:

(A) The comparative columns are provided for review and explanation of fluctuations.

(B) Components which total to an amount believed not significant enough to merit audit attention may be grouped as one amount.

.331 Accounts Receivable - Other

	Initials	Date
Prepared By		
Approved By		

(1) (2) Due from	(3) (4) Explanation	(5) Final bals.	(6) Balances Per client	(7) AJEs Dr (Cr)	(8) Final
Describe individual components deemed significant enough for application of auditing procedures.					
	Subtotal				
Other					
Total					

Date	Prepared By	Work Paper No
	Reviewed By	

ABC Co.

.332 Accounts Receivable - Analytical Procedures

12/31/X5

G/L A/C No.		Balance 12/31/X4	Balance 12/31X5	Difference	W/P Ref Follow Up Of Material Differences
	Accounts Receivable - Gross				
	Sales - Gross				
Ratio Analysis"		19X4	19X5		
No. of Days Net Sales in Trade Accounts Receivable: Trade A/R / Sales/365					
Year End Trade Accounts Receivable As A Percentage Of Gross Sales: Trade A/R / Sales					
A/R Turnover: Credit Sales / Average A/R					
A/R Collection Period 365 Days / A/R Turnover					

Date	Prepared By	Work Paper No
	Reviewed By	

.333 Accounts Receivable - Analytical Procedures

G/L A/C No.		Balance	Balance	Difference	W/P Ref Follow Up Of Material Differences
	Accounts Receivable - Gross				
	Sales - Gross				
Ratio Analysis					
No. of Days Net Sales in Trade Accounts Receivable: $\frac{\text{Trade A/R}}{\text{Sales/365}}$					
Year End Trade Accounts Receivable As A Percentage Of Gross Sales: $\frac{\text{Trade A/R}}{\text{Sales}}$					
A/R Turnover: $\frac{\text{Credit Sales}}{\text{Average A/R}}$					
A/R Collection Period $\frac{\text{365 Days}}{\text{A/R Turnover}}$					

.340

ABC Company
Allowance for Doubtful Accounts - Related Expense
12/31/X5

	Initials	Date
Prepared By		
Approved By		

Description	Final Balance 12/31/X4	Activity 19X5 Prov. for Expense	Write offs	Recoveries	Bal 12/31/X5	
If there are significant individual components, describe or cross reference to a supporting paper that presents particulars.						
Totals per client	xxxxx	xxxxx	(xx xxx)	xxxx	xxxxx	
Adjustments: (describe)		xxxx			xxxx	
Final	xxxxx	xxxx	(xxxxx)	xxxx	xxxxx	

.341 *Allowance for Doubtful Accounts - Related Expense*

	Initials	Date
Prepared By		
Approved By		

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	Description		Final Balance	Activity Prov. for Expense	Write offs	Recoveries	Bal	
1								
2								
3								
4								
5								
6								
7								
8								
9								
10								
11								
12								
13								
14								
15								
16	Totals per client							
17								
18	Adjustments:							
19	(describe)							
20								
21	Final							
22								
23								
24								
25								
26								
27								
28								
29								
30								
31								
32								
33								
34								
35								
36								
37								
38								
39								
40								

.350

ABC Company

Allowance for Doubtful Accounts, Provisions, Write Offs and Recoveries

	Initials	Date
Prepared By		
Approved By		

(1)		(2)	(3)	(4)	(5)	(6)	(7)	(8)
			Carryforward Analysis (A)					
1		Balance, beginning of year						
2		Add: Provision						
3		Less: Balance, end of year						
4		Net write offs for year						
5		Add back recoveries restored to allowance (B)						
6		Gross write offs						
7		Account (credit) sales for year						
8	a	Trade accounts receivable						
8	b	Trade notes receivable						
8	c	Total trade accts. & notes receivable						
9		Receivables turnover (line 7 divided by line 8c)						
10		Average collection period in days (360 divided by line 9) (C)						
11		Net write offs as % of acct. sales (line 4 divided by line 7)						
12		Allowance as % of receivables (line 3 divided by line 8c)						

(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
19X0	19X1	19X2	19X3	19X4	19X5	19X6	
xxxx							
xxxx							
xxxx							
(xxxx)							
xxxx							
xxx							
xxxx							
360000							
29000							
1000							
30000							
12							
30 days							
xx%							
xx%							

NOTES:

(A) Depending on the circumstances, an auditor may find it useful to maintain continuing analysis of the allowance for doubtful accounts and related activity. For clients with a small number of significant trade accounts receivable, an auditor may decide it is more practical to review each balance individually and may consider this type of schedule as unnecessary.

(B) In this illustration, it is assumed that recoveries of accounts written off are restored to the allowance.

(C) A 360 day year was used in this illustration to simplify computations.

.351 Allowance for Doubtful Accounts, Provisions, Write Offs and Recoveries

	Initials	Date
Prepared By		
Approved By		

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
		Carryforward Analysis					
1	Balance, beginning of year						
2	Add: Provision						
3	Less: Balance, end of year						
4	Net write offs for year						
5	Add back recoveries restored to allowance						
6	Gross write offs						
7	Account (credit) sales for year						
8 a	Trade accounts receivable						
8 b	Trade notes receivable						
8 c	Total trade accts. & notes receivable						
9	Receivables turnover (line 7 divided by line 8c)						
10	Average collection period in days (360 divided by line 9)						
11	Net write offs as % of acct. sales (line 4 divided by line 7)						
12	Allowance as % of receivables (line 3 divided by line 8c)						

	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)

Date	Prepared By	Work Paper No
	Reviewed By	

ABC Co.

.352 Allowance for Doubtful A/C's - Analytical Procedures

12/31/X5

G/L A/C No.		Balance 12/31/X4	Balance 12/31/X5	Difference	W/P Ref Follow Up Of Material Differences
	Allowance - Doubtful A/C's				
	Bad Debt Provision				
	Sales - Returns & Allowances				
Ratio Analysis:		19X4	19X5		
Sales Returns/Gross Sales					
Bad Debt Provision/Gross Sales					
Allowance/Accounts Receivable					

Date	Prepared By	Work Paper No
	Reviewed By	

.353 Allowance for Doubtful A/C's - Analytical Procedures

G/L A/C No.		Balance	Balance	Difference	W/P Ref Follow Up Of Material Differences
	Allowance - Doubtful A/C's				
	Bad Debt Provision				
	Sales - Returns & Allowances				
Ratio Analysis:					
Sales Returns/Gross Sales					
Bad Debt Provision/Gross Sales					
Allowance/Accounts Receivable					

.360

ABC Company
Inventories - Lead Sheet
12/31/X5

	Initials	Date
Prepared By		
Approved By		

(1) W.P. Ref	(2)–(3) Account title (B)	(4) Account No.	(5) Final 12/31/X4	(6) Per Client 12/31/X5	(7) Adjustments (A) Dr (Cr)	(8) as adjusted 12/31/X5
	Raw materials					
	Work in process					
	Finished goods					
	Supplies					
	Cost of sales	(C)				
	Ratios (describe)	(D)				

NOTES:

(A) This paper may be expanded for such purposes as providing additional columns for reclassifications, and using separate debit and credit columns for adjustments.

(B) These account titles might be far more complex than the above. Work-in-process accounts, for example, might be expanded to identify separate processes, departments or plants.

(C) It may be useful to also present data from related expense accounts and selected ratio analyses on the inventory lead sheet.

(D) Some firms require that the lead sheet also include the auditor's individual conclusions on the audit objectives, work done and resulting findings.

.361

Inventories - Lead Sheet

	Initials	Date
Prepared By		
Approved By		

(1) W.P. Ref	(2) Account title	(3)	(4) Account No.	(5) Final	(6) Per Client	(7) Adjustments (A) Dr (Cr)	(8) as adjusted
	Raw materials						
	Work in process						
	Finished goods						
	Supplies						
	Cost of sales						
	Ratios (describe)						

.370

ABC Company
Inventory - Analysis from Physical to Year End (A)
12/31/X5

	Initials	Date
Prepared By		
Approved By		

(1) (2) (3) (4)	(5) Raw Materials	(6) Work in Process	(7) Finished Goods	(8) Supplies
Balance per books 11/30/X5	xxxxxx	xxxxx	xxxxxx	xxxxx
Adjustment of books to physical (B)	xxxx	(xxxx)	(xxxx	xxxx
Per physical 11/30/X5	xxxxxx	xxxxx	xxxxxx	xxxxx
December 19X5 activity				
Purchases-raw materials-supplies	xxxxxx			xxx
Requisitions-	(xxxxxx)	xxxxx		(xxxx)
Direct labor		xxxxxx		
Overhead		xxxxxx		
		xxxxxx		
Cost of goods manufactured		(xxxxxx)	xxxxxx	
			xxxxxx	
Cost of goods sold			(xxxxxx)	
Other (describe)				
Balance 12/31/X5	xxxxxx	xxxxx	xxxxxx	xxxxx

NOTES:

(A) This type of analysis will vary greatly with the circumstances. For example, some clients may use several general ledger accounts for production and inventory while others may have a small number of general ledger controlling accounts that are tied to a detailed cost accounting system. Other obvious variables include the following:

- Assumptions on the flow of cost (FIFO, LIFO, etc.).
- Method of cost accounting (process, job order, direct costing for internal reports and adjustment to absorbtion costing for external reporting, standard costs, retail method, etc.).

(B) Adjustment may be more complex than a simple difference between the book balances and the priced physical inventory. This may require a separate analysis of adjustments to the inventory per books and/or the physical.

.371 Inventory - Analysis from Physical to Year End

	Initials	Date
Prepared By		
Approved By		

(1) (2) (3) (4)	(5) Raw Materials	(6) Work in Process	(7) Finished Goods	(8) Supplies
Balance per books				
Adjustment of books to physical				
Per physical				
activity				
Purchases-raw materials-supplies				
Requisitions-				
Direct labor				
Overhead				
Cost of goods manufactured				
Cost of goods sold				
Other (describe)				
Balance				

.380

ABC Company

Inventory - Test Counts 11/30/X5 (A) (B) 12/31/X5

	Initials	Date
Prepared By		
Approved By		

Ticket No. or other ref. [B]	Location & Description (Part #) [B]	Count per Client	Count per Auditor	Difference test over (under) client
	Department A			
-xxxx	xxxx xxxxxx	xx	xx	—
xxxx	xxxx xxxxxx	xx	xx	x
xxxx	xxxx xxxxxx	xx	xx	(x)
	Department B			
xxxx	xxx x xxxxxx	xxx	xxx	—
xxxx	xxxx xxx xxx	xxx	xxx	—

NOTES:

(A) The design of test count work sheets will depend on the circumstances and may vary extensively from the above which is assumed to involve simple unit counts. Other physical inventories, for example, may involve conversion of units to weight, surveys of volume with conversion to tonnage, or special techniques such as engineering surveys of volume, aerial photography, and chemical analyses.

(B) For each item, the location, reference, description and other data must provide sufficient detail for subsequent tracing of the auditor's test counts or observations into the client's compilation and summarization of its physical inventory. Accordingly, advance planning is extremely important in preparing for observation and testing of a client's physical inventory. Provision should be made for inclusion in the working papers of such information as number of tickets used, unused and voided, or the number of count sheets used.

.381 Inventory - Test Counts

Initials	Date
Prepared By		
Approved By		

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Ticket No. or other ref.	Location & Description (Part #)			Count per Client	Count per Auditor	Difference test over (under) client	

ABC Company

.390 Inventory Price Test - Raw Materials (A)

12/31/X5

	Initials	Date
Prepared By		
Approved By		

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
			Per Phys. Inventory				
Ref. to Physical (B)	Description (including part number)		Dollar Amt	Quantity	Unit Price	Name of Vendor	
Recap of dollar coverage							
Total dollars tested					%		
Total dollar amount of raw materials inventory					100 %		

NOTES:

(A) The approach and resulting working papers for price testing will vary with the circumstances (for example, if ABC priced its inventory at standard costs, and/or used LIFO).

(B) This column provides for practical cross reference to the client's physical inventory as priced, extended and summarized. Examples include page numbers, ticket or tag numbers, etc.

(C) Prices for test purposes are from most recent invoices (including related shipping expense) for an appropriate quantity.

(D) Consideration of individual differences and their aggregate effect is a matter for the auditor's judgment in the circumstances. The auditor should be mindful of ARB No. 43, Chapt. 4 on inventory pricing.

(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
Price Test (C)							
Date	Invoice or Vou No	Quantity	Unit price	Diff., test is over (under) phys.	Dollar effect of diff. on inventory	Remarks (D)	
		Total differences (D)					

.391 Inventory Price Test - Raw Materials

	Initials	Date
Prepared By		
Approved By		

(1) Ref. to Physical	(2)(3) Description (including part number)	(4) Per Phys. Inventory Dollar Amt	(5) Quantity	(6) Unit Price	(7)(8) Name of Vendor
	Recap of dollar coverage				
	Total dollars tested			$	
	Total dollar amount of raw materials inventory			$	

Price Test				Diff., test is over(under) phys.	Dollar effect of diff. on inventory	Remarks
Date	Invoice or Vou No	Quantity	Unit price			
		Total differences				

[The next page is 6623.]

Inventory Price Tests of Work-in-Process and Finished Goods—General Note on Working Papers

.400 The working paper formats for price tests of work-in-process and finished goods inventories will vary with the circumstances of individual engagements. Among the variables are the following:

- The client's particular industry and business.
- Cost accounting method (job order or process cost, use of standard costs, application of overhead costs, retail method).
- Assumptions about flow of costs (FIFO, LIFO, moving average).
- Other cost accounting matters such as allocation of costs to various products included in inventories.

Because of the many complex variables involved, sample working papers on price tests of work-in-process and finished goods inventory are not presented. However, the following possible column headings may be useful in considering working paper formats for price tests of specific items of work-in-process and finished goods inventory:

Part number or product code

Job order number

Description

Department or plant location

Quantity in inventory

Date produced (is it slow-moving or obsolete?)

Material cost

Labor cost

Overhead cost

Total cost

Unit cost

Inventory dollar amount

Status (stage of completion, process code no., etc.)

Recent actual job order cost

Recent process or standard unit cost

Recent actual selling price and gross profit percentage (is it adequate?)

Recent sales volume (is item slow-moving or obsolete?)

Depending on the circumstances, it may be more efficient to use copies of the client's analyses and prepare supplementary schedules rather than develop completely separate analysis formats.

Date	Prepared By	Work Paper No
	Reviewed By	

ABC Co.

.401 Inventories - Analytical Procedures

12/31/X5

G/L A/C			Balance 12/31/X4	Balance 12/31/X5	Difference	W/P Ref. Follow Up Of Material Differences
	Inventory					
	Cost of Sales					
	Gross Profit					
Ratio Analysis:			19X4	19X5		
Raw Material/Total Inventory						
W/P /Total Inventory						
Finished Goods/Total Inventory						
Inventory Turnover: (Cost of Sales/Average Inventory)						

Date	Prepared By	Work Paper No
	Reviewed By	

.402 **Inventories · Analytical Procedures**

G/L A/C		Balance		Difference	W/P Ref. Follow Up Of Material Differences
	Inventory				
	Cost of Sales				
	Gross Profit				
Ratio Analysis:					
Raw Material/Total Inventory					
W/P /Total Inventory					
Finished Goods/Total Inventory					
Inventory Turnover: (Cost of Sales/Average Inventory)					

.410

ABC Company
Prepaid Insurance and Related Expense (A)
12/31/X5

	Initials	Date
Prepared By		
Approved By		

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
			Coverage				
Company	Pol No	Type		Amt	Coinsurance	Policy Date	

NOTES:

(A) The column headings of this analysis may also be those of the client's insurance register. It may be practical for the client to prepare this schedule as a time saver.

(B) If the schedule includes insurance costs that are expensed entirely in the year incurred, the column for insurance expense should support the balance in the client's insurance expense account(s).

(C) The opening balance would be the final balance per the preceding year's working papers.

(D) The adjustment(s) should be adequately explained; a symbol and footnote may suffice.

(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
Terms of Coverage					19X5 Activity (B)		
From	To	Original Premium	Monthly Amortization	Ppd Ins. bal. 12/31/X4 (C)	Payments (refunds)	Insurance Expense	Ppd Ins. bal. 12/31/X5
		Totals					
		Adjustment (D)				(xxx)	(xxx)
		Final					

.411 Prepaid Insurance and Related Expense

	Initials	Date
Prepared By		
Approved By		

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Company		Pol No	Coverage Type		Amt	Coinsurance	Policy Date
1							
2							
3							
4							
5							
6							
7							
8							
9							
10							
11							
12							
13							
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34							
35							
36							
37							
38							
39							
40							

(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
Terms of Coverage		Original Premium	Monthly Amortization	Ppd Ins. bal.	Activity		Ppd Ins. bal.
From	To				Payments (refunds)	Insurance Expense	
		Totals					
		Adjustment					
		Final					

ABC Company

.420 Prepaid Insurance (Alternative Format)

12/31/X5

	Initials	Date
Prepared By		
Approved By		

(1) (2) (3)	(4) Total A/C # XXX	(5) XYZ Fire Ins Co.	(6) XYZ Casualty Co.	(7) Blanket Insurance Co.	(8)
Policy numbers					
Coverages:					
Types					
Amount					
Book value of assets insured					
Terms of coverage					
From					
To					
Premium amount					
Monthly write-off					
Prepaid bal 12/31/X4					
Additions					
Expense					
Prepaid bal 12/31/X5					

.421 Prepaid Insurance

	Initials	Date
Prepared By		
Approved By		

	(1)	(2)	(3)	(4) Total A/C #	(5)	(6)	(7)	(8)
Policy numbers								
Coverages:								
Types								
Amount								
Book value of assets insured								
Terms of coverage								
From								
To								
Premium amount								
Monthly write-off								
Prepaid bal								
Additions								
Expense								
Prepaid bal								

.430

ABC Company
Property Taxes - Prepaid & Accrued (A)
12/31/X5

	Initials	Date
Prepared By		
Approved By		

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
← Property →							
Taxing Organization		Location & description			Assessed Value	Total Tax	Payment date

NOTES:

(A) This analysis may support prepaid expenses included among assets, accrued taxes included among liabilities and tax expenses. The auditor's preference determines whether this analysis is filed among papers on assets, liabilities or expenses. However, the amounts should be cross-referenced with their location in lead sheets that support all relevant statement groupings.

(B) The column for expenses incurred may include write-offs of prepaid amounts and provisions for amounts incurred but not yet paid. This will depend on the timing of the payment due dates and periods covered for each taxing organization.

(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
		Final Bal 12/31/X4		19X5 Activity		Bal 12/31/X5	
Period	Covered	Prepaid	Accured	Payments	Expense incurred (B)	Prepaid	Accrued
From	To						

.431 Property Taxes - Prepaid & Accrued

	Initials	Date
Prepared By		
Approved By		

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	Property							
	Taxing Organization		Location & description			Assessed Value	Total Tax	Payment date
1								
2								
3								
4								
5								
6								
7								
8								
9								
10								
11								
12								
13								
14								
15								
16								
17								
18								
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37								
38								
39								
40								

(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
		Final Bal		Activity		Bal	
Period	Covered	Prepaid	Accrued	Payments	Expense incurred	Prepaid	Accrued
From	To						

.440

ABC Company
Prepaid expenses - other
12/31/X5

	Initials	Date
Prepared By		
Approved By		

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Acct No.	Description		Period covered From To	Bal 12/31/X4	Additions	Charges to expense	Bal 12/31/X5

.441 Prepaid expenses - other

	Initials	Date
Prepared By		
Approved By		

	(1) Acct No.	(2) Description	(3)	(4) Period covered From To	(5) Bal	(6) Additions	(7) Charges to expense	(8) Bal
1								
2								
3								
4								
5								
6								
7								
8								
9								
10								
11								
12								
13								
14								
15								
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.442 ABC Co.

Prepaid Expenses - Analytical Procedures

12/31/X5

Date	Prepared By	Work Paper No
	Reviewed By	

	G/L A/C No.			Balance 12/31/X4	Balance 12/31/X5	Difference	W/P Ref Follow Up of Material Differences
1		Prepaid Expenses					
2							
3							
4							
5							
6							
7							
8							
9							
10							
11							
12							
13							
14							
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37							
38							
39							
40							

.443

Date	Prepared By	Work Paper No
	Reviewed By	

Prepaid Expenses - Analytical Procedures

G/L A/C No.		Balance	Balance	Difference	W/P Ref Follow Up of Material Differences
	Prepaid Expenses				

.450

ABC Company
Deposits & Miscellaneous Current Assets
12/31/X5

	Initials	Date
Prepared By		
Approved By		

(1) Client's Acct No.	(2)	(3) Description	(4)	(5) Final Bal. 12/31/X4	(6) Bal per client 12/31/X5	(7) Adjustments Dr (Cr)	(8) Final Bal. 12/31/X5

NOTES:

The comparative format may aid in review of fluctuations at the detail level.

Symbols and legends may be used to indicate confirmation and/or other procedures applied, and as cross-references to explanatory notes if required, concerning individual balances or disposition of prior year balances.

.451 **Deposits & Miscellaneous Current Assets**

	Initials	Date
Prepared By		
Approved By		

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	Client's Acct No.	Description			Final Bal.	Bal per client	Adjustments Dr (Cr)	Final Bal.
1								
2								
3								
4								
5								
6								
7								
8								
9								
10								
11								
12								
13								
14								
15								
16								
17								
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.460

ABC Company
Property, Plant & Equipment, & Rel Depcn-Lead Analysis (C)
12/31/X5

	Initials	Date
Prepared By		
Approved By		

(1) (2) (3)	(4)	(5)	(6)	(7)	(8)
	ASSETS (A)				
Classification	Final Bal 12/31/X4	Additions	Retirements & dispositions	Other Dr (Cr)	Bal 12/31/X5
Land	xx xxx				xx xxx
Buildings	xxx xxx				xxx xxx
Machinery & equipment	xxx xxx	x xxx	x xxx		xxx xxx
Furniture & fixtures	xx xxx	xxx	xxx		xx xxx
Automobiles	xx xxx	x xxx	x xxx		xx xxx
Leasehold improvements	x xxx			(xxx)	x xxx
	xxx xxx	x xxx	x xx	(xxx)	xxx xxx

NOTES:

(A) Some auditors may prefer to split this information into two analyses, ie: (1) property plant & equipment asset accounts, and (2) Accumulated depreciation. Some auditors may also expand the analysis to show separate line items for various depreciable lives.

(B) This lead analysis, in addition to supporting the financial statements, can be tailored to group information needed if the client is required to file reports with regulatory agencies.

(C) This information on distribution of depreciation and amortization could be shown elsewhere in other working papers with only a cross-reference shown here.

(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
		Accumulated Depreciation-Amortization (A)					
W.P. Ref.	Depreciation method & life	Final Bal. 12/31/X4	Additions	Retirements & dispositions	Other	Bal 12/31/X5	W.P. Ref
		xxxxx	xxxx			xxxxx	
		xxxxx	xxxx	xxxx		xxxxx	
		xxxx	xxxx	xxx		xxxx	
		xxxx	xxx	xxxx		xxxx	
		xxxxx	xxxx	xxxx		xxxxx	
Add: depreciation and amortization (if any) credited directly against the asset balance			xxx				
Total depreciation & amortization			xxxx (C)				
Depreciation & amortization distributed to:							
Manufacturing costs			xxxx				
Selling expense			xxx				
Gen & administrative			xxx				
			xxxx (C)				

	Initials	Date
Prepared By		
Approved By		

.461 Property, Plant & Equipment, & Rel Depcn-Lead Analysis

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
				ASSETS				
	Classification			Final Bal	Additions	Retirements & dispositions	Other Dr (Cr)	Bal
1								
2	Land							
3								
4	Buildings							
5								
6	Machinery & equipment							
7								
8	Furniture & fixtures							
9								
10	Automobiles							
11								
12	Leasehold improvements							
13								
14								
15								
16								
17								
18								
19								
20								
21								
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23								
24								
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27								
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31								
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(9) W.P. Ref.	(10) Depreciation method & life	(11) Accumulated Depreciation-Amortization: Final Bal.	(12) Additions	(13) Retirements & dispositions	(14) Other	(15) Bal	(16) W.P. Ref
Add: depreciation and amortization (if any) credited directly against the asset balance							
Total depreciation & amortization							
Depreciation & amortization distributed to:							
Manufacturing costs							
Selling expense							
Gen & administrative							

.470

ABC Company
Property Plant & Equipment - Additions (A)
12/31/X5

	Initials	Date
Prepared By		
Approved By		

Date	Ref	Vendor	Description	Depreciable Life	Cost
		Describe individual additions including whether item is new or used (B)			
		Subtotal, additions of over XXX each			
		Other, each of XXX or less			
		Total additions (B)			
		Analysis for investment credit (C):			
		Deduct excess of used property over limitation (C)			
		Fraction for qualified portion			
		Qualified amounts (C)			

NOTES:

(A) This illustration is assumed to support a particular category such as machinery and equipment which may include property that qualifies for an investment tax credit. Some auditors may prefer to group all additions on one schedule and use analysis columns to segregate amounts into such classifications as land, buildings, machinery and equipment. Then a separate analysis may be prepared concerning additions which qualify for the investment tax credit.

(B) Depending on the circumstances, an auditor may have all additions listed or select a minimum dollar amount and have only those additions over that amount listed.

(C) Auditors should carefully consider applicable income tax requirements.

(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
	Analysis for Investment Credit by Depreciable Life (C)						
		New Eligible Property			Used Eligible Property		
Not eligible	Total eligible	7 or more	5 to under 7	3 to under 5	7 or more	5 to under 7	3 to under 5
					( )	( )	( )
			X2/3	X1/3		X2/3	X1/3

.471 Property Plant & Equipment - Additions

	Initials	Date
Prepared By		
Approved By		

(1) Date	Ref	(2) Vendor	(3)	(4) Description	(5)	(6)	(7) Depreciable Life	(8) Cost
		Describe individual additions including whether item is new or used						
		Subtotal, additions of over each						
		Other, each of or less						
		Total additions						
		Analysis for investment credit:						
		Deduct excess of used property over limitation						
		Fraction for qualified portion						
		Qualified amounts						

(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
	Analysis for Investment Credit by Depreciable Life						
		New Eligible Property			Used Eligible Property		
Not eligible	Total eligible	7 or more	5 to under 7	3 to under 5	7 or more	5 to under 7	3 to under 5
					( )	( )	( )

ABC Company

.480 Property Plant - Equipment - Retirements & Dispositions

12/31/X5

	Initials	Date
Prepared By		
Approved By		

	(1) Date sold disposed	(2) Classification & Description	(3)	(4)	(5) Date acquired	(6) Depreciation Method	(7) Life	(8) Cost
1								
2								
3								
4								
5								
6								
7								
8								
9								
10								
11								
12								
13								
14								
15								
16								
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NOTE:

The auditor may find it useful to use additional analysis columns to aid in such matters as tax return preparation. For example, columns may be used to distinguish ordinary and capital gains and losses, and to identify recapture, if any, of depreciation and/or investment tax credits.

(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
Accum. depre-ciation	Net carrying value	Proceeds of disp.	Net gain or loss	See note			

.481 Property Plant - Equipment - Retirements & Dispositions

	Initials	Date
Prepared By		
Approved By		

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	Date sold disposed	Classification & Description			Date acquired	Depreciation Method	Life	Cost
1								
2								
3								
4								
5								
6								
7								
8								
9								
10								
11								
12								
13								
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40								

	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
	Accum. depre- ciation	Net carrying value	Proceeds of disp.	Net gain or loss	See	note		

Date	Prepared By	Work Paper No.
	Reviewed By	

ABC Co.

.482 Fixed Assets - Analytical Procedures

12/31/X5

G/L A/C No.		Balance 12/31/X4	Balance 12/31X5	Difference	W/P Ref Follow Up Of Material Differences
	Building				
	Machinery & Equipment				
	Furniture & Fixtures				
	Fixed Assets - Capital Lease				
	Accumulated Amortization - Capital Leases				
	Accumulated Depreciation - Building				
	Accumulated Depreciation - Machinery & Equipment				
	Accumulated Depreciation - Furniture & Fixtures				
	Depreciation Expense				
	Repairs & Maintenance				
Ratio Analysis:					
Depreciation - Building/Building (Cost)					
Accum Depr - Building/Building (Cost)					
Depreciation - M & E/M & E (Cost					
Accum Depr - M & E/M & E (Cost)					
Depreciation - F & F/F & F (Cost)					
Accum Depr - F & F/F & F (Cost)					
Depreciation - Cap Leases/Cap Leases					
Accum Amort - Cap Leases/Cap Leases					

Date	Prepared By	Work Paper No
	Reviewed By	

.483 Fixed Assets - Analytical Procedures

G/L A/C No.		Balance	Balance	Difference	W/P Ref Follo Up Of Materia Differences
	Building				
	Machinery & Equipment				
	Furniture & Fixtures				
	Fixed Assets - Capital Lease				
	Accumulated Amortization - Capital Leases				
	Accumulated Depreciation - Building				
	Accumulated Depreciation - Machinery & Equipment				
	Accumulated Depreciation - Furniture & Fixtures				
	Depreciation Expense				
	Repairs & Maintenance				

Ratio Analysis:

Depreciation - Building/Building (Cost)				
Accum Depr - Building/Building (Cost)				
Depreciation - M & E/M & E (Cost				
Accum Depr - M & E/M & E (Cost)				
Depreciation - F & F/F & F (Cost)				
Accum Depr - F & F/F & F (Cost)				
Depreciation - Cap Leases/Cap Leases				
Accum Amort - Cap Leases/Cap Leases				

.490

ABC Company
Intangible Assets
12/31/X5

	Initials	Date
Prepared By		
Approved By		

(1) (2) Description	(3) Balance 12/31/X4	(4) Additions at cost	(5) Deductions Charged to P&L	(6) Deductions Charged to other A/Cs	(7) Other Additions (Deductions)	(8) Balance 12/31/X5
Describe significant individual components.						

NOTE: This type of analysis might be arranged as follows for carryforward purposes:

	Total intangibles	Organization Costs	Goodwill acq - XYZ Co.	Goodwill acq - DEF Co.
Date incurred		12/31/X2	5/30/X3	4/1/X4
Amortizable life		60 months	10 years	40 years
Orig Cost incurred		xxxx	xxxxx	xxxx
Monthly charge		xx	xxx	xx
Annual charge		xxx	xxxx	xxx
Balance 12/31/X2	xxxx	xxxx		
Additions	xxxxx		xxxxx	
Amortization	xxxx	xxx	xxxx	
Bal 12/31/X3	xxxxx	xxxx	xxxxx	
Additions	xxxx			xxxx
Amortization	xxxx	xxx	xxxx	xxx
Bal 12/31/X4	xxxxx	xxxx	xxxxx	xxxx
Additions				
Amortization	xxxxx	xxx	xxxx	xxx
Bal 12/31/X5	xxxxx	x xxx	xxxxx	xxxx

.491

Intangible Assets

	Initials	Date
Prepared By		
Approved By		

(1) (2)	(3)	(4)	(5)	(6)	(7)	(8)
			Deductions			
Description	Balance	Additions at cost	Charged to P&L	Charged to other A/Cs	Other Additions (Deductions)	Balance
Date incurred						
Amortizable life						
Orig Cost incurred						
Monthly charge						
Annual charge						
Balance						
Additions						
Amortization						
Bal						
Additions						
Amortization						
Bal						
Additions						
Amortization						
Bal						

Date	Prepared By	Work Paper No
	Reviewed By	

ABC Co.

.492 Intangible Assets - Analytical Procedures
12/31/X5

G/L A/C No.			Balance 12/31/X4	Balance 12/31/X5	Difference	W/P Ref Follow Up Of Material Differences
	Intangible Assets					
	Deferred Charges					
	Accumulated Amortization					
	R&D Expense					
Ratio Analysis:						
R&D Expense/Sales						

Date	Prepared By	Work Paper No
	Reviewed By	

.493 Intangible Assets - Analytical Procedures

G/L A/C No.		Balance	Balance	Difference	W/P Ref Follow Up Of Material Differences
	Intangible Assets				
	Deferred Charges				
	Accumulated Amortization				
	R&D Expense				

Ratio Analysis:

R&D Expense/Sales

.500

ABC Company

Accounts Payable - Lead Sheet

	Initials	Date
Prepared By		
Approved By		

(1)	(2) (3)	(4)	(5)	(6)	(7)	(8)
			12/31/X5			
Client's acct. no. or code	Acct title	Final bal 12/31/X4	Per client	AJEs (Dr) Cr	as adjusted	W.P. Ref.
	Trade accts payable					
	(If comprised of a group of general ledger account balances, list the individual accounts to show how they group to the total for trade accounts payable.)					
	Other current payables					
	(It may be practical to include the groupings general ledger accounts for other current payables on the same lead sheet, especially if consideration is given to showing one balance sheet classification for trade and other accounts payable.)					

.501 Accounts Payable - Lead Sheet

Initials	Date
Prepared By		
Approved By		

	(1) Client's acct. no. or code	(2) (3) Acct title	(4) Final bal	(5) Per client	(6) AJEs (Dr) Cr	(7) as adjusted	(8) W.P. Ref.
1							
2		Trade accts payable					
3							
4							
5							
6							
7							
8							
9							
10		Other current payables					
11							
12							
13							
14							
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.510

ABC Company

Trade Accounts Payable - Schedule (A)

12/31/X5

	Initials	Date
Prepared By		
Approved By		

Source: ...... Note (B)

Vendor	Balance 12/31/X5	Remarks
XYZ Corp	xxxx	(D)
TUV Industries	xxx	
P&Q Company	xxxx	
L and Sons	xxx	
John Doe Mfg	xxxx	
Other, each under xxx dollars (NOTE (C))	xxxx	
Total	xxxx	

NOTES:

(A) Many auditors believe this schedule should be prepared by the client and would have a staff auditor prepare this listing only as a last resort. However, some auditors, depending on their understanding of the internal control structure, may believe this type of schedule need not be included in their working papers.

(B) This schedule should include indication of where the detail was obtained, for example, "per voucher register." In some instances, it may be a carbon or photocopy of the client's own year end tabulation of trade payables.

(C) This type of schedule may include all trade payables as of the balance sheet date or only those over a given amount selected by the auditor.

(D) A symbol and explanation may be used to identify amounts subjected to examination of supporting evidence and/or confirmation procedures (See section 5400.250 in the chapter on audit objectives and programs regarding confirmation of accounts payable).

.511

Trade Accounts Payable - Schedule

	Initials	Date
Prepared By		
Approved By		

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	Source:	Vendor			Balance	Remarks		
1								
2								
3								
4								
5								
6								
7								
8								
9								
10								
11								
12								
13								
14								
15								
16								
17								
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.520

ABC Company
Unrecorded Liabilities Test
12/31/X5

	Initials	Date
Prepared By		
Approved By		

(1) Check No Vou No or Other Ref	(2) Vendor	(3)	(4) Date Received	(5) Description	(6)	(7)	(8) Account code charged

NOTES:

(A) This working paper should indicate the particular period selected and records examined in the search for unrecorded liabilities, for example, cash disbursements book and voucher register for 1/2/X6-1/31/X6. The period selected will vary with the circumstances, for example, effectiveness of client's internal control, billing pattern of client's vendors (do they bill quickly or slowly after delivery of goods or services) and whether other audit procedures such as confirmation of payables are to be used.

(B) If amounts selected are subject to a minimum amount(s), this should also be indicated on this working paper, for example, "selected all items of $XXX or over," or "selected all items of $100 for 1/1-1/10, all items of $500 and over for 1/11-1/20 and all items of $1000 and over from 1/20 to date of audit report."

(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
Amount affects		Desposition					
P&L	Bal sheet						

.521 Unrecorded Liabilities Test

	Initials	Date
Prepared By		
Approved By		

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	Check No Vou No or Other Ref	Vendor		Date Received	Description			Account code charged
1								
2								
3								
4								
5								
6								
7								
8								
9								
10								
11								
12								
13								
14								
15								
16								
17								
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37								
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(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
Amount affects		Desposition					
P&L	Bal sheet						

.530

ABC Company
Accounts Payable - Confirmation Differences
12/31/X3

	Initials	Date
Prepared By		
Approved By		

(1) W.P. Ref	(2) Vendor	(3)	(4)	(5)	(6) Balance per Books	(7) Balance per Confirm	(8) Confirm over (under) books

(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
← Analysis of confirm difference →							
Unrecorded Liab	Payment in transit	Shipment in transit	Discount taken	Other	Remarks		

.531 Accounts Payable - Confirmation Differences

	Initials	Date
Prepared By		
Approved By		

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
					Balance per		
W.P. Ref	Vendor				Books	Confirm	Confirm over (under) books

(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
← Analysis of confirm difference →							
Unrecorded Liab	Payment in transit	Shipment in transit	Discount taken	Other	Remarks		

.532

Date	Prepared By	Work Paper No
	Reviewed By	

ABC Co.

Accounts Payable - Analytical Procedures

12/31/X5

G/L A/C No.		Balance 12/31/X4	Balance 12/31/X5	Difference	W/P Ref Follow Up Of Material Differences
	Trade Accounts Payable				
	Purchases				

Ratio Analysis:

Accounts Payable Turnover:

$$\frac{\text{(Cost of Sales - Beginning Inventory) + Ending Inventory}}{\text{Average Accounts Payable}}$$

A/P - Days Outstanding:

$$\frac{365}{\text{Accounts Payable Turnover}}$$

.533

Date	Prepared By	Work Paper No
	Reviewed By	

Accounts Payable - Analytical Procedures

G/L A/C No.		Balance	Balance	Difference	W/P Ref Follow Up Of Material Differences
	Trade Accounts Payable				
	Purchases				

Ratio Analysis:

Accounts Payable Turnover:

$$\frac{(\text{Cost of Sales} - \text{Beginning Inventory}) + \text{Ending Inventory}}{\text{Average Accounts Payable}}$$

A/P - Days Outstanding:

$$\frac{365}{\text{Accounts Payable Turnover}}$$

ABC Company

.540 Miscellaneous Current Liabilities

12/31/X5

	Initials	Date
Prepared By		
Approved By		

(1) Acct. No.	(2) (3) Description	(4) Balance 12/31/X4	(5) Balance 12/31/X5	(6) (7) Remarks	(8)

NOTE:

Depending on materiality and the assessed level of control risk for relevant assertions, the auditor may limit work to review of comparative amounts. Generally, the auditor's concern relates to searching for unrecorded liabilities.

.541 Miscellaneous Current Liabilities

	Initials	Date
Prepared By		
Approved By		

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Acct. No.	Description		Balance		Remarks		

.550

DEF Company
Dividends Payable
12/31/X5

	Initials	Date
Prepared By		
Approved By		

	Preferred (A)	Common (A)
Final bal 12/31/X4	———	———
Add: Declarations (Describe including reference to minutes & applicable number of shares per working papers on capital stock) (B)		
Total declared	———	———
Less: Payments (Describe including testing of payments) (B)		
Total paid	———	———
Balance 12/31/X5	═══	═══

NOTES:

(A) This illustration assumes that the client has only one class each of preferred and common stock. The analysis columns may be expanded if more classes of capital stock are present. However, if the timing of the dividend declarations and payment dates results in no year end liability for unpaid dividends, the testing shown on this working paper may appear in an analysis of retained earnings, and this paper would be unnecessary.

(B) If the auditor prefers, the detail of individual dividends declared may be presented in an analysis of retained earnings with a cross reference of unpaid dividends to a recap or lead sheet concerning other payables.

.551

Dividends Payable

	Initials	Date
Prepared By		
Approved By		

	(1)	(2)	(3)	(4)	(5)	(6) Preferred	(7) Common	(8)
1		Final bal						
2								
3		Add: Declarations (Describe including						
4		reference to minutes & applic-						
5		able number of shares per work-						
6		ing papers on capital stock)						
7								
8		Total declared						
9								
10		Less: Payments (Describe including						
11		testing of payments)						
12								
13		Total paid						
14								
15		Balance						
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ABC Company
Liability for Payroll Taxes Withheld
12/31/X5

	Initials	Date
Prepared By		
Approved By		

(1) Client's Acct	(2)–(3) Description	(4) Final Bal 12/31/X4	(5) Bal per client 12/31/X5	(6) AJEs Incr. (Decr.)	(7) Bal as adjusted 12/31/X5	(8)
	Federal income tax					
	FICA					
	State income tax					
	Other (describe)					

NOTE:

Depending on the auditor's assessment of control risk, these balances may be tested by reference to subsequent payments and related payroll tax returns, and by analytical procedures.

.561 Liability for Payroll Taxes Withheld

	Initials	Date
Prepared By		
Approved By		

(1) Client's Acct	(2) (3) Description	(4) Final Bal	(5) Bal per client 12/31/X5	(6) AJEs Incr. (Decr.)	(7) Bal as adjusted 12/31/X5	(8)
	Federal income tax					
	FICA					
	State income tax					
	Other (describe)					

.570

ABC Company

Accrued Payroll Taxes

12/31/X5

	Initials	Date
Prepared By		
Approved By		

(1) Client's Acct Code	(2)–(3) Description	(4) Final Bal 12/31/X4	(5) Bal client 12/31/X5	(6) AJEs Increase (Decrease)	(7) Bal as adjusted 12/31/X5	(8)
	FICA - employer's share					
	FUI					
	SUI					
	Other (describe)					

NOTE:

Depending on the auditor's assessment of control risk for the relevant assertions, these balances may be tested by reference to subsequent payments and related payroll tax returns, and by analytical procedures.

.571 Accrued Payroll Taxes

	Initials	Date
Prepared By		
Approved By		

(1) Client's Acct Code	(2) (3) Description	(4) Final Bal	(5) Bal client	(6) AJEs Increase [Decrease]	(7) Bal as adjusted	(8)
	FICA - employer's share					
	FUI					
	SUI					
	Other					

.580

ABC Company
Accrued Payroll
12/31/X5

	Initials	Date
Prepared By		
Approved By		

			Components of Accrual (A)	
TEST				
Total payroll week ended Fri 12/28, paid 1/3		100%	xxxxx	
Total payroll week ended Fri 1/4 paid 1/9		xxxxx		
12/19-12/31	2 days	33%	xxxx	
1/1-1/4	4 days	67%		
(12/30=Sunday - Sundays paid separately if worked per Union Contract & company pol)				
Amount per test			xxxxx	
Amount per client			xxxxx	(B)
Difference				(B)

NOTES:

(A) Depending on circumstances, the auditor may find it practical to expand this column to an analysis by components, for example, production wages, office salaries and officers salaries.

(B) The auditor may also wish to note on this working paper the accrual as of the prior year end and comment on fluctuation if significant.

.581 Accrued Payroll

	Initials	Date
Prepared By		
Approved By		

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
						Components of Accrual	

TEST

Total payroll week ended , paid

Total payroll week ended paid

Amount per test

Amount per client

Difference

.590

ABC Company
Accruals - Other
12/31/X5

	Initials	Date
Prepared By		
Approved By		

(1) Client's	(2) Title or descrip-	(3) tion	(4) W.P. Ref	(5) 12/31/X4 Final	(6) 12/31/X5 Per Client	(7) AJEs Incr (Decr)	(8) Bal as adjusted
	Property	taxes	(A)				
	Other,	describe	(B)				

NOTES:

(A) Accrued property taxes should be cross-referenced to the working paper on property taxes prepaid accrued and expensed. See section 6500.430.

(B) The auditor may evaluate the significance or relative immateriality of other accruals and then decide whether to limit work to inquiry of the client and analytical procedures, or to perform additional tests.

.591

Accruals - Other

	Initials	Date
Prepared By		
Approved By		

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Client's	Title or	description	W.P. Ref	Final	Per Client	AJEs Incr(Decr)	Bal as adjusted

.600

ABC Company
Debt - Notes Payable & Related Interest (A)
12/31/X5

	Initials	Date
Prepared By		
Approved By		

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
← Description (B) →					← Principal (C) →		
Orig. date	Type of debt &	maturity	Face Amt	Interest rate	Bal 12/31/X4	Additions	Payments

NOTES:

(A) This analysis illustrates how the activity and balances of principal and related interest can be presented on the same working paper. This approach may result in more effective working paper presentation of the analysis and testing performed and expedite review. It may be practical to prepare separate analyses for each broad category of debt such as notes payable, collateralized long term debt, debenture bonds, capitalized leases, etc.

(B) The description should include the type of debt, face amount, stated interest rate, payment terms, maturity date, collateral, if any, and original discount or premium, if any. If the description requires too much space, some of it may be continued on attached sheets.

(C) In some instances, long term debt may be administered by a trust company or institutional lender and be combined with a restrictive indenture and a predetermined payment schedule for principal and interest. In such instances, a copy of the payment schedule and indenture may serve as carryforward (or permanent file) working papers, and the principal columns on this schedule restricted to the year end balance which would be positively confirmed. The columns for interest and discount or premium and the description would be retained.

(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
Bal	Current Portion	Related Interest					
		Final Bal 12/31/X4		Interest	Interest	Bal 12/31/X5	
12/31/X5	12/31/X5	Accr Int	Prem (Disc)	Expense	paid	Accr Int	Prem (Disc)

NOTES (continued)

(D) Depending on the circumstances, the following additional information may be needed:

- Amount authorized by the indenture
- Amount issued and not retired or cancelled
- Amounts held by the client
- Amounts held in sinking funds
- Amounts held by affiliates (consolidated and/or unconsolidated)

.601 **Debt - Notes Payable & Related Interest**

	Initials	Date
Prepared By		
Approved By		

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Description					Principal		
Orig. date	Type of debt & maturity		Face Amt	Interest rate	Bal	Additions	Payments

(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
Bal	Current Portion	Related Interest					
		Final Bal		Interest Expense	Interest paid	Bal	
		Accr Int	Prem(Disc)			Accr Int	Prem(Disc

.610

XYZ Company

Debt - Summary of Assets Pledged

12/31/X5

	Initials	Date
Prepared By		
Approved By		

Description of Asset	Creditor & description	Liability Bal 12/31/X5	Book val of asset 12/31/X5
Accounts receivable	NOP Factors 3/15/X5 Financing agreement	xxxxx	xxxxx
Inventory-finished goods	NOP Factors 4/15/X5 Financing agreement	xxxxx	xxxxx
Property, plant-equip 10 milling machines	LMN Mfg Corp 2/28/X4 conditional sales agreement-last payment due 1/31/X9	xxxxx	xxxxx
Building #3	PQ Life Insurance Co 4/1/X2 Mortgage Note matures 3/31/Y9	xxxxxx	xxxxxx
Fire Insurance - XYZ Insurance Co Policy 11/15/X5-11/15/X6	TUV Brokerage and Finance Corp Note payable	xxxx	xxxx

.611

Debt - Summary of Assets Pledged

	Initials	Date
Prepared By		
Approved By		

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Description of Asset		Creditor & description			Liability Bal	Book val of asset	

.612

ABC Co.

Notes Payable and Debt - Analytical Procedures
12/31/X5

Date	Prepared By	Work Paper No
	Reviewed By	

G/L A/C No.			Balance 12/31/X4	Balance 12/31/X5	Difference	W/P Ref Follow Up Of Material Differences
	Notes Payable					
	Long Term Debt					
	Interest Expense					
Ratio Analysis:						
Long Term Debt/Stockholder Equity						
Interest Expense/Net Sales						
Average Balance:						
Long Term Debt						
Notes Payable						

.613

Notes Payable and Debt - Analytical Procedures

Date	Prepared By	Work Paper No
	Reviewed By	

G/L A/C No.		Balance	Balance	Difference	W/P Ref Follow Up Of Material Differences
	Notes Payable				
	Long Term Debt				
	Interest Expense				
Ratio Analysis:					
Long Term Debt/Stockholder Equity					
Interest Expense/Net Sales					
Average Balance:					
Long Term Debt					
Notes Payable					

ABC Company

.620 Federal (State) Income Taxes-Accrued & Provided (A)

12/31/X5

	Initials	Date
Prepared By		
Approved By		

(1)	(2)	(3)	(4)	(5)	(6) Acct Totals	(7) Current year 19X5	(8) 19X4
Accrued payable 12/31/X4							
(Refundable) 12/31/X4 (C)							
Payments and/or (recoveries) in 19X5							
Itemize and describe individual cash transactions (D)							
Provision - current year (E)							
Accrued payable 12/31/X5 (F)							
Deferred taxes (G)							

NOTES:

(A) This type of analysis may be prepared separately for federal income taxes and state and local income taxes or depending on the circumstances, federal and state income taxes may be presented on a single spread analysis.

(B) This illustration assumes that several prior years are still open and provides individual columns as a means for matching each transactions with related provisions for each open year.

(C) A separate line item for refundable taxes is provided to segregate those amounts from taxes payable.

(D) Details of individual payments including date, description and amount should be shown separately because of the compliance implications in the timing and amounts of payments.

(E) Generally, development of the current year's provision involves enough detail to require a separate working paper cross-referenced to this type of account analysis.

(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
Prior	open years (B)						
19X3	19X2	19X1	19X0				

NOTES (continued)

(F) In some circumstances, the auditor may prepare (or obtain from the client) this type of analysis through a preliminary date and after testing and review with the client, the schedule may be subsequently brought forward to the year and date.

(G) Deferred taxes are included in separate illustrative working papers at paragraphs .640-.643.

.621 Federal (State) Income Taxes-Accrued & Provided

	Initials	Date
Prepared By		
Approved By		

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
					Acct Totals	Current year	
Accrued payable							
(Refundable)							
Payments and/or (recoveries) in							
Itemize and describe individual cash transactions							
Provision - current year							
Accrued payable							
Deferred taxes							

(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
Prior	open years						

.630

ABC Company
Provision for Federal (State) Income Taxes
12/31/X5

	Initials	Date
Prepared By		
Approved By		

(1) (2) (3) (4) (5) (6) (7) (8)

Income before federal and state income taxes, per books

Add and/or (Deduct) interperiod timing differences

(Describe individually and cross reference to working papers that provide sources of data and further determination of deferred tax provisions and related balance sheet classifications.)

Add and/or (Deduct) permanent differences

(Describe specifically and cross reference to source working papers. For some situations such as tax exempt municipal bond interest, state and local income tax requirements may differ from those for federal income taxes.)

Estimated taxable income - state-local

Less: provisions for state-local income taxes

Estimated taxable income - federal

Tax computations

Estimated tax provision

(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
Federal income tax				State income tax			
For current ret.	Timing differences			For current ret.	Timing differences		
	Amt	Tax effect			Amt	Tax effect	

.631 Provision for Federal (State) Income Taxes

	Initials	Date
Prepared By		
Approved By		

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Income before federal and state income taxes, per books								
Add and/or (Deduct) interperiod timing differences								
Add and/or (Deduct) permanent differences								
Estimated taxable income - state-local								
Less: provisions for state-local income taxes								
Estimated taxable income - federal								
Tax computations								
Estimated tax provision								

(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
Federal income tax				State income tax			
For current ret.	Timing differences			For current ret.	Timing differences		
	Amt	Tax effect			Amt	Tax effect	

Date	Prepared By	Work Paper No
	Reviewed By	

.640 ABC Company

Deferred Income Taxes & Temporary Differences (A)

12/31/X5

	1 Book Basis	2 Tax Basis	3 Temporary Difference	4 Future 19X6
ASSETS:				
Cash	25000	25000	-0-	
Inventory	600000	650000	<50000>	<50000>
P.P. & E (Net)	800000	400000	400000	<65000>
	1425000	1075000		
LIABILITIES:				
Accounts Payable	120000	120000	-0-	
Warranty Obligation	300000	-0-	<300000>	<45000>
	210000	120000		
Taxable <Deductible> Amounts			50000	<160000>
Carryforward of Net Deductible Amounts				160000
Carryback of Net Deductible Amounts				
Net Taxable <Deductible> Amounts				-0-
			Total	
Currently Enacted Tax Rates: (B)				
15% of First 50000			7500	-0-
25% of Next 25000				
34% of Amount Over 75000				
			7500	-0-
Deferred Tax Balances - 12/31/X5				
Current Portion - *19X6*			-0-	
Non Current Portion			7500	
Journal Entry:			Adjustment	
	12/31/X5	12/31/X4	<DR> CR	
Current Portion	-0-	<1000>	1000	
Non Current Portion	7500	7700	<200>	
	7500	6700	800	
Income Statement (Select Accounts)	(Book Income - 300,000)			
	19X5	(Taxable Income - 350,000)		
Pretax Income	300000			
Income Tax Expense				
Current	107250			
Deferred	800			
	108050			
Net Income	191950			
Effective Tax Rate	36%			

Years	Reversals - Taxable <Deductible>	
19X7	19X8	19X9
185000	205000	75000
<65000>	<85000>	<105000>
120000	120000	<30000>
<120000>	<40000>	
	<30000>	30000
-0-	50000	-0-
-0-	7500	-0-
-0-	7500	-0-

Notes:

(A) This schedule assumes there are no net operating losses in the current or prior years. Calculation of deferred tax assets is illustrated in section 6500.642.

(B) "Shortcut" techniques such as applying an average tax rate or the company's highest tax rate to net taxable amounts are permitted by FASB Statement No. 96 provided the results do not materially differ from those obtained by strict application of graduated tax rates.

(C) This illustration addresses only federal deferred income taxes. Separate schedules of temporary differences and deferred income taxes for each taxing jurisdiction should be prepared.

.641

Date	Prepared By	Work Paper No.
	Reviewed By	

Deferred Income Taxes & Temporary Differences

	1 Book Basis	2 Tax Basis	3 Temporary Difference	4 Future
ASSETS:				
LIABILITIES:				
Taxable <Deductible> Amounts				
Carryforward of Net Deductible Amounts				
Carryback of Net Deductible Amounts				
Net Taxable <Deductible> Amounts				
Currently Enacted Tax Rates:				
15% of First 50000				
25% of Next 25000				
34% of Amount Over 75000				
Deferred Tax Balances				
Current Portion				
Non Current Portion				
Journal Entry:				
Current Portion				
Non Current Portion				

5	6	7	8	9	10	
Years	Reversals - Taxable <Deductible>					
						1
						2
						3
						4
						5
						6
						7
						8
						9
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Date	Prepared By	Work Paper No.
	Reviewed By	

ABC Co.

.642 Deferred Income Taxes & Temporary Diferences (A)
12/31/X5

	Temporary Differences	Future Years Reversals -- Taxable <Deductibles>			
	19X5	19X6	19X7	19X8	19X9
Inventory	<50000>	<50000>			
PP & E (Net)	400000	<65000>	185000	205000	75000
Warranty Obligation	<300000>	<45000>	<65000>	<85000>	<105000>
Taxable <Deductible> Amounts	50000	<160000>	120000	120000	<30000>

CASE I - Carrybacks to taxes paid in 19X4 are available for $120000 of 19X6's net deductible amount. No taxes to be paid in 19X5.

		19X6	19X7	19X8	19X9
Carryback to 19X4		120000			
Carryforward to 19X7		40000	<40000>		
Carryback to 19X7			<30000>		30000
Net Taxable Deductible Amounts		-0-	50000	120000	-0-
Deferred Tax Asset - Current (120000 Carried Back @ 46%)				55200	
Deferred Tax Liability - Non Current (50000 @ 34%					
(120000 @ 34%)				57800	

CASE II - Loss Carryforward only (no taxable income in prior years to which deductible amounts may be carried back)

		19X6	19X7	19X8	19X9
Totals, As Above		<160000>	120000	120000	<30000>
Carryforward		160000	<120000>	<40000>	
Carryback to 19X8				<30000>	30000
		-0-	-0-	50000	-0-
Deferred Tax Liability - Non Current (50000 @ 34%)				17000	

NOTES:

(A) These examples illustrate the effects of carrybacks and carryforwards of net operating losses and net deductible amounts on the computation of deferred income taxes under various circumstnaces.

ASSUMPTIONS:

(1) Additional originating difference of $65000 in depreciation arises in 19X6.
(2) Tax rates: 19X4 - 46%, 19X5 - 40%, 19X6 and later - 34%
(3) No material difference arises between application of graduated rates versus maximum rates

(CONTINUED)

Date	Prepared By	Work Paper No
	Reviewed By	

ABC Co.

.642 Deferred Income Taxes & Temporary Differences

12/31/X5

	19X6	19X7	19X8	19X9
CASE III - Loss carryforward only, and NOL carryforward of $20000 from 19X4				
Totals, As Above	<160000>	120000	120000	<30000>
NOL Carryforward		<20000>		
Carryforward	160000	<100000>	<60000>	
Carryback			<30000>	30000
	-0-	-0-	30000	-0-
Deferred Tax Liability - Non Current (30000 @ 34%)			10200	
CASE IV - Operating Loss of $190000 in 19X5, of which $100000 may be carried back to 19X4.				
Totals, As Above	<160000>	120000	120000	<30000>
NOL - 19X7		<90000>		
Carryforward to 19X8 and X9	150000	<30000>	<120000>	
	<10000>	-0-	-0-	<30000>
Refundable Income Taxes (100000 @ 46%)			46000	
Unrecognizable Net Deductible Amounts (Unrecognizable because there are no periods to which the amounts may be carried back or forward.)			40000	

[The next page is 6709.]

Date	Prepared By	Work Paper No.
	Reviewed By	

.643 Deferred Income Taxes & Temporary Diferences

	1	2	3	4	5	6	7
			Temporary Differences	Future Years Reversals -- Taxable <Deductibles>			
1							
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.650

ABC Company
Contingent Liabilities and Commitments Other Than Leases
12/31/X5

	Initials	Date
Prepared By		
Approved By		

(1) W.P. Ref.	(2)–(5) Classification and Description (A)	(6) Amount	(7)–(8) Disposition (C)

NOTES:

(A) See SAS No. 12, paragraphs 5-7 on audit procedures regarding litigation, claims and assessments. Also see SAS No. 19 on Client Representations.

(B) Working paper references may include those on review of minutes, standard bank confirmations, review of agreements and contracts, review of legal fees, inquiries of management and lawyers' letters.

(C) Disposition column may include reference to footnote disclosure, inclusion in the client representation, and, if necessary, the item's effect on the auditor's report.

ABC Company

.651 Contingent Liabilities and Commitments Other Than Leases

	Initials	Date
Prepared By		
Approved By		

(1) W.P. Ref.	(2)–(3) Classification and Description	(4)	(5)	(6) Amount	(7)–(8) Disposition

ABC Company

.660 Capital Stock & Additional Pd in Capital-Analysis

12/31/X5

	Initials	Date
Prepared By		
Approved By		

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
			Capital stock, par val X per share				Additional paid in capital
			Auth No. of shares		XXXXX		
			No. of shares issued	Amount	No. of shs held in treasury	Cost of treas. stock	
Balance 12/31/X4							
Describe individual transactions and cross-reference to authorization per minutes or per such agreements as options and/or warrants.							
Balance 12/31/X5							

NOTES:

It may be helpful to prepare this type of analysis as a carryforward working paper.

If several classes of capital stock are present, the analysis can be prepared on wider columnar paper to use the additional columns for the various classes of stock.

	Initials	Date
Prepared By		
Approved By		

.661 *Capital Stock & Additional Pd in Capital-Analysis*

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
				Capital stock, par val per share				Additional paid in capital
				Auth No. of shares				
				No. of shares issued	Amount	No. of shs held in treasury	Cost of treas. stock	
Balance								
Balance								

ABC Company

.670 Capital Stock - Certificate Book Examination
(Carry Forward)

	Initials	Date
Prepared By		
Approved By		

Exam Done by	Exam Date	Unissued Ctf Nos. From-To	Name to whom issued	Certificate Issued: Ctf No.	Certificate Issued: Date issued	Certificate Issued: No. of shares
			Albert Able	1	3/15/X0	500
			Bartholomew Baker	2	3/15/X0	500
WCF	1/15/X1	3 - 100	Re 12/31/X0			
			Carlton P. Charlie	3	4/1/X1	250
WCF	1/5/X2	4 - 100	Re 12/31/X1			
			Carlton P. Charlie	4	12/30/X2	250
JD	1/10/X3	5 - 100	Re 12/31/X2			
RR	1/12/X4	5 - 100	Re 12/31/X3			
RR	1/3/X5	5 - 100	Re 12/31/X4			
			Francine P. Able	5	5/30/X5	100
			Albert Able	6	5/30/X5	400
			Godfrey Delta	7	9/2/X5	100
			Mary Baker	8	10/31/X5	100
			Bartholomew Baker	9	10/31/X5	400
ES	1/3/X6	10 - 100	Re 12/31/X5			
ES	1/3/X7	10 - 100	Re 12/31/X6			

(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
Ctfs retired or transferred			Number of shares outstanding, per ctf. book				
Date ret or trfd	No. of shares	Ctf no. of new shares	12/31/X0	12/31/X1	12/31/X2, X3, X4	12/31/X5, X6	
5/30/X5	500	5 & 6	500	500	500		
10/31/X5	500	8 & 9	500	500	500		
			1000				
				250	250	250	
				1250			
					250	250	
					1500		
					1500		
					1500		
						100	
						400	
						100	
						100	
						400	
						1600	
						1600	

	Initials	Date
Prepared By		
Approved By		

.671 Capital Stock - Certificate Book Examination (Carry Forward)

	(1) Exam Done by	Date	(2) Unissued Ctf Nos. From-To	(3)–(5) Name to whom issued	(6) Certificate Issued: Ctf No.	(7) Date issued	(8) No. of shares
1							
2							
3							
4							
5							
6							
7							
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(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
Ctfs retired or transferred			Number of shares outstanding, per ctf. book				
Date ret or trfd	No. of shares	Ctf no. of new shares					

.680

ABC Company
Retained Earnings - Analysis
(Carryforward)

	Initials	Date
Prepared By		
Approved By		

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
		19X0	19X1	19X2	19X3	19X4	19X5
Balance, beginning of year							
Net income for year							
Dividends declared and paid: (Describe) (A)							
Balance, end of year							

NOTE:

(A) If more than one class of stock is present; segregate dividends into groups according to each class of stock.

.681

Retained Earnings - Analysis
(Carryforward)

	Initials	Date
Prepared By		
Approved By		

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Balance, beginning of year								
Net income for year								
Dividends declared and paid:								
Balance, end of year								

Revenue and Expense Working Papers—General Note

.690 Working papers on revenue and expense accounts would include comparative lead sheets for each income statement classification. Expenses such as depreciation, insurance, interest, and the provision for doubtful accounts would be cross-referenced to related analyses included among working papers concerning the balance sheet classifications.

The auditor, after considering his evaluation of the internal control structure, may decide that analytical procedures (see SAS No. 56 [AU section 329]) and substantive tests of balance sheet accounts (including related income and expense effects) provide enough evidence to avoid the need for detailed analysis of most individual revenue and expense accounts. Some revenue and expense accounts, however, are ordinarily analyzed and tested because of the following:

- Identification of possible disclosure matters (especially lawyers' billings).
- Information needed for preparation of tax returns and other reports.
- Generalized titles that make accounts subject to misclassifications and errors.

Accounts requiring separate analyses generally are:

Legal expenses and other professional fees

Maintenance and repairs

Travel and entertainment

Officers' salaries and expenses

Taxes, licenses, and fees

Rents and royalties

Contributions

Advertising

For timesaving purposes, the auditor may request the client to prepare analyses of these accounts and to assemble the related vouchers and other supporting documents.

.700

ABC Company
Legal Expense
12/31/X5

	Initials	Date
Prepared By		
Approved By		

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Name of lawyer or law firm			Description of matter (A)			Date of billing	Amount
		Total 19X5					
		Total 19X4 (B)					

NOTES:

(A) Descriptions should be related (referenced) to such other working papers as contingencies and commitments and management representations.

(B) The final amount from the preceding year may be useful for comparison purposes. A significant fluctuation should be explained.

(C) A similar working paper format may be used for other professional fees.

.701 Legal Expense

	Initials	Date
Prepared By		
Approved By		

(1) (2) Name of lawyer or law firm	(3)	(4) (5) (6) Description of matter	(7) Date of billing	(8) Amount
	Total			
	Total			

.710

ABC Company
Maintenance & Repairs Expense
12/31/X5

	Initials	Date
Prepared By		
Approved By		

Date	Check or Vou. No.	Vendor	Description	Amount
	Subtotal, details requested (A)			
	All other, each of which is under $XXX (A)			
	Total			
	Memo - final total 12/31/X4 (B)			

NOTES:

(A) The auditor may decide to limit testing to items over a certain dollar amount, based on the client's capitalization policy, rather than all components of the account. If so, the limits should be indicated.

(B) The final amount for the preceding year may be useful for comparison purposes. A significant fluctuation should be explained.

.711 Maintenance & Repairs Expense

	Initials	Date
Prepared By		
Approved By		

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	Date	Check or Vou. No.	Vendor		Description			Amount
1								
2								
3								
4								
5								
6								
7								
8								
9								
10								
11								
12		Subtotal, details requested (						
13								
14		All other, each of which is under $						
15		Total						
16								
17		Memo - final total						
18								
19								
20								
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.720

ABC Company

Officers Salaries and Expense

12/31/X5

	Initials	Date
Prepared By		
Approved By		

(1) (2) Name of officer and position	(3) Social security no.	(4) Time devoted to business	(5) Percent of corp. stock owned Common	(6) Preferred	(7) Amount of compensa.	(8) Expense account allowance
	Total					
	Final amount 19X4*					

* The final amount from the preceding year may be useful for comparison purposes. A significant fluctuation should be explained.

.721 Officers Salaries and Expense

	Initials	Date
Prepared By		
Approved By		

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Name of officer and position		Social security no.	Time devoted to business	Percent of corp. stock owned Common	Preferred	Amount of compensa.	Expense account allowance
		Total					
		Final amount					

.730

ABC Company
Taxes, Licenses and Fees
12/31/X5

	Initials	Date
Prepared By		
Approved By		

(1)–(4)	(5) 19X4	(6) 19X5	(7)	(8)
State and local income taxes				
(Relate to balance sheet analysis working papers on income taxes accrued and provided, or provide details)				
Property taxes				
(Relate to balance sheet analysis working papers on property taxes prepaid and accrued, or provide details)				
Payroll taxes				
FICA				
SUI				
FUI				
(Relate to balance sheet analysis working papers on payroll taxes accrued, or provide details)				
Other taxes, licenses and fees				
(Describe in detail)				
Totals				

.731 Taxes, Licenses and Fees

	Initials	Date
Prepared By		
Approved By		

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
State and local income taxes								
Property taxes								
Payroll taxes								
FICA								
SUI								
FUI								
Other taxes, licenses and fees								
Totals								

.740

ABC Company
Rents and Royalties (A)
12/31/X5

	Initials	Date
Prepared By		
Approved By		

(1)–(3)	(4)	(5)	(6)	(7)	(8)
		← 19X5		→	
	19X4 Final as reported (B)	Per client	AJEs Incr (Decr)	as adjusted	W.P. Ref
Rents					
(Describe and cross-reference to working papers on the underlying leases.)					
Royalties					
(Describe and cross-reference to working papers on the underlying royalties.)					

NOTES:

(A) Separate schedules may be prepared for rents, and for royalties if more practical.

(B) If the fluctuation between the current and preceding year is significant, it should be explained.

.741 Rents and Royalties

	Initials	Date
Prepared By		
Approved By		

	(1)	(2)	(3)	(4) Final as reported	(5) Per client	(6) AJEs Incr(Decr)	(7) as adjusted	(8) W.P. Ref
1								
2	Rents							
3								
4								
5								
6								
7								
8								
9								
10								
11								
12								
13	Royalties							
14								
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.750

ABC Company
Interest Expense Recap
12/31/X5

	Initials	Date
Prepared By		
Approved By		

(1) W.P. Ref. (A)	(2)–(4) Description (A)	(5) Final 19X4	(6) Per client 19X5	(7) AJEs incr(decr)	(8) as adjusted 19X5
	Notes payable				
	Long term debt				
	Capitalized leases				
	Other (describe) (B)				
	Total		(B)		

NOTES:

(A) Generally, the significant components of interest expense should be totals cross-referenced from applicable balance sheet analyses of the underlying debt and its related interest accruals and expense.

(B) If the difference between amounts for the current and preceding year are significant, they should be explained.

.751 Interest Expense Recap

	Initials	Date
Prepared By		
Approved By		

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
W.P. Ref.	Description			Final	Per client	AJEs incr(decr)	as adjusted
	Notes payable						
	Long term debt						
	Capitalized leases						
	Other						
	Total						

.760

ABC Company
Other Income
12/31/X5

	Initials	Date
Prepared By		
Approved By		

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Date	Received From			Description			Amount

.761 Other Income

	Initials	Date
Prepared By		
Approved By		

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Date	Received From			Description			Amount

.770

ABC Company
Other Expense
12/31/X5

	Initials	Date
Prepared By		
Approved By		

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Date	Payee		Description				Amount

.771

Other Expense

	Initials	Date
Prepared By		
Approved By		

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	Date	Payee		Description				Amount
1								
2								
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Date	Prepared By	Work Paper No
	Reviewed By	

ABC Co.

.772 Expense Accounts - Analytical Procedures

12/31/X5

G/L A/C No.		Balance 12/31/X4	Balance 12/31/X5	Difference	W/P Ref Follow Up Of Material Differences
	Legal Expense				
	Officers Salaries				
	Taxes & Licenses				
	Rents & Royalties				
	Other Income				
	Other Expense				

Date	Prepared By	Work Paper No
	Reviewed By	

.773 Expense Accounts – Analytical Procedures

	G/L A/C No.		Balance	Balance	Difference	W/P Ref Follow Up Of Material Differences
1		Legal Expense				
2		Officers Salaries				
3		Taxes & Licenses				
4		Rents & Royalties				
5		Other Income				
6		Other Expense				
7						
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AAM Section 7000

CORRESPONDENCE, CONFIRMATIONS & REPRESENTATIONS

These samples are presented for illustrative purposes only. They are intended as mere conveniences for users of this Manual who may want points of departure when designing their own formats to meet their individual needs. These illustrations are neither all inclusive nor are they prescribed minimums. Auditors and accountants are to rely on professional standards and their individual professional judgment in determining what may be needed in the circumstances.

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[The next page is 7101.]

AAM Section 7100
Control of Confirmations and Correspondence

.01 Generally, clients prepare correspondence and confirmation requests on their own letterhead and submit to the auditor the signed originals and copies. The auditor may obtain one or more copies to serve as file copies for the current working papers, second requests and manuscript copies for the next engagement.

.02 There are two types of confirmation requests: the positive form and the negative form. Some positive forms request the respondent to indicate whether he or she agrees with the information stated on the request. Other positive forms, referred to as blank forms, do not state the amount (or other information) on the confirmation request, but request the recipient to fill in the balance or furnish other information.

.03 The negative form requests the recipient to respond only if he or she disagrees with the information stated on the request. Negative confirmation requests may be used to reduce audit risk to an acceptable level when (*a*) the combined assessed level of inherent and control risk is low, (*b*) a large number of small balances is involved, and (*c*) the auditor has no reason to believe that the recipients of the requests are unlikely to give them consideration.

.04 The confirmation requests should be reviewed to the extent the auditor considers necessary. For example, the auditor may perform the following for accounts receivable confirmation requests before they are mailed:

- Compare the names and addresses to the client's records.
- Compare balances per confirmation requests to the subsidiary ledger.

.05 The requests would then be stuffed in envelopes and submitted to the post office under the auditor's control.

.06 The auditor controls the mailings and receipt of responses so that the confirmation process is independent of the client.

.07 Mailing envelopes have the auditor's office or post office box number as the return address so that undeliverable letters are returned to the auditor and not to the client. For mailings, the auditor may provide the envelopes or affix a label on the client's envelope that covers the client's return address and replaces it with the auditor's address.

.08 Reply envelopes addressed to the auditor are enclosed with the request letter. Reply envelopes generally have prepaid postage to encourage responses. Some auditors also use codes on the reply envelopes so that responses may be sorted by engagement before the mail is opened. This feature may be particularly useful when there are several engagements that involve voluminous mailings.

.09 If the client objects to use of the auditor's name and address, some auditors suggest that a post office box in the client's name be used, with the returns to be opened under the auditor's control for the confirmation process, and that the post office be instructed that after the box is closed subsequent mail be forwarded to the auditor.

[The next page is 7201.]

AAM Section 7200
Requests for Confirmations and Related Materials

Wording of Confirmation Request Forms

.01 Forms and correspondence used for confirmation requests should state clearly that the client is requesting that a reply be sent to the CPA. Forms and correspondence used for information requests for engagements other than audits should not refer to "an audit." They should also use the term "accountant(s)" rather than "auditors." Suggested wording follows:

> Please send the following information to our certified public accountants (insert name and address of accountants) who are performing accounting services for the company.

.02 The samples of correspondence in this section include language that refers to auditors and an audit of the client's financial statements on the assumption that an audit is being performed. This language needs to be modified if services other than an audit are being performed.

.03 Request for Bank Cutoff Statements

(Prepared on client's letterhead)

(Date [Note (A)])

Financial Institution Official*
First United Bank
Anytown, USA 00000

Dear Financial Institution Official:

In connection with an audit of the financial statements of (name of customer) as of (balance-sheet date) and for the (period) then ended, we request that you send the following information directly to our auditors (insert name and address of auditors) as of the close of business (insert date):

1. The information requested on the enclosed standard form(s) to confirm account balance information with your financial institution.
2. For the account numbers listed below, statement(s) of our account(s) and the related paid checks for the period from (insert date) to (insert date) inclusive.

Account Number	Account Name
__________	__________
__________	__________
__________	__________
__________	__________

3. [Note (B)]

Sincerely,

(Name of Customer)

____

By: ____________________

NOTES TO USER:

(A) The request should be sent at least ten days prior to the audit date so the bank will be able to provide the information requested and to render the cutoff statements as requested. If the request does not reach the bank before the cutoff date, the cutoff statement will include transactions after that date.

(B) The letter may also include requests for:

- Confirmation of all securities or other items held for the clients account as of the closing date for collection or safekeeping, or as agent or trustee (a listing should be provided including titles and account numbers).
- Confirmation of the list of authorized signers for the above accounts. (This may have been previously requested at a preliminary date in connection with the assessment of control risk.)

* This letter should be addressed to a financial institution official who is responsible for the financial institution's relationship with the client or is knowledgeable about the transactions or arrangements. Some financial institutions centralize this function by assigning responsibility for responding to confirmation requests to a separate function. Independent auditors should ascertain the appropriate recipient.

.04

STANDARD FORM TO CONFIRM ACCOUNT BALANCE INFORMATION WITH FINANCIAL INSTITUTIONS

CUSTOMER NAME

Financial Institution's Name and Address [ ]

[ ]

We have provided to our accountants the following information as of the close of business on ________________, 19___, regarding our deposit and loan balances. Please confirm the accuracy of the information, noting any exceptions to the information provided. If the balances have been left blank, please complete this form by furnishing the balance in the appropriate space below.* Although we do not request nor expect you to conduct a comprehensive, detailed search of your records, if during the process of completing this confirmation additional information about other deposit and loan accounts we may have with you comes to your attention, please include such information below. Please use the enclosed envelope to return the form directly to our accountants.

1. At the close of business on the date listed above, our records indicated the following deposit balance(s):

ACCOUNT NAME	ACCOUNT NO.	INTEREST RATE	BALANCE*

2. We were directly liable to the financial institution for loans at the close of business on the date listed above as follows:

ACCOUNT NO./ DESCRIPTION	BALANCE*	DATE DUE	INTEREST RATE	DATE THROUGH WHICH INTEREST IS PAID	DESCRIPTION OF COLLATERAL

(Customer's Authorized Signature) (Date)

The information presented above by the customer is in agreement with our records. Although we have not conducted a comprehensive, detailed search of our records, no other deposit or loan accounts have come to our attention except as noted below.

(Financial Institution Authorized Signature) (Date)

(Title)

EXCEPTIONS AND/OR COMMENTS

Please return this form directly to our accountants: [ ]

[ ]

* Ordinarily, balances are intentionally left blank if they are not available at the time the form is prepared.

Approved 1990 by American Bankers Association, American Institute of Certified Public Accountants, and Bank Administration Institute. Additional forms available from: AICPA – Order Department, P.O. Box 1003, NY, NY 10108-1003

D451 5951

[The next page is 7205.]

.05 Request for Confirmation of Petty Cash Fund and Advances to Employees

(Prepared on client's letterhead)

(Date)

(Name)
(Address)

Our auditors, (insert name and address of auditors) are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the balance of the petty cash fund (or amount of advances) in your possession as of December 31, 19XX which was shown by our records as $______.

Please indicate in the space provided below whether the amount above agrees with your records. If not, please send the auditors any information you have that will help them reconcile the difference.

After signing and dating your reply, please return it directly to the auditors. A stamped, addressed envelope is enclosed for your convenience.

Very truly yours,
(Client's authorized signature)

____

The foregoing information is in agreement with my records as of December 31,19XX with the following exceptions (if any):

....
....
....

Date: .... Signed:...

.06 Securities and Cash in Custodian or Trust Accounts

(Prepared on client's letterhead)

(Date)

(Name of custodian or trustee)
(Address)

Our auditors, (insert name and address of auditors) are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the enclosed list of securities owned at (insert date) and the amount of principal and income and amount of cash held by you at that date for each of the following accounts [Notes (B) & (C)]:

(If a list is not obtained from the client, the auditor should complete the following for each account:

	Name of account	Account No. [Note (A)]	Amount Held
1.	....	....	....
2.	....	....	....
3.	....	....	....)

Please also indicate to the auditors whether to your knowledge any of the securities are pledged or otherwise encumbered.

Please mail your reply directly to the auditors. A stamped, addressed envelope is enclosed for your convenience.

Very truly yours,
(Client's authorized signature)

NOTES TO USER:

(A) Use the custodian or trustee's account number.

(B) This letter may be expanded, if necessary, to request cutoff statements of activity (principal and interest) in the accounts.

(C) Sometimes this request is combined with a request for cutoff bank statements and the standard form to confirm account balance information with financial institutions. However, it may be more practical to send separate letters because a bank's commercial banking and trust departments are usually separate operations.

.07 Securities Held by Brokers

(Prepared on client's letterhead)

(Date) [Note (A) below]

(Broker's Name)
(Address)

In connection with the audit of our financial statements, please send directly to our auditors (insert name and address of auditors), a statement of our account(s) [Note (B)] with you as of (insert date), indicating the following information:

1. Securities held by you for our account.
2. Securities out for transfer to our name.
3. Any amounts payable to or due from us.

Please mail your reply directly to the auditors. A stamped, addressed envelope is enclosed for your convenience.

Very truly yours,
(Client's authorized signature)

NOTES TO USER:

(A) The request should be sent so it reaches the broker sufficiently in advance of the listing date for the broker to respond in a practical manner.

(B) It may be helpful to include the account number(s) used by the broker for the client's account(s).

.08 Sample Receipts for Return of Cash or Securities Counted by Auditor's Representative, and Cutoff Bank Statements Received Directly by the Auditors

Cash Count

The above detailed items were counted in my presence and returned to me intact by (insert individual's name), representative of (insert auditor's firm name).

(Date and Time) Custodian ....
(custodian's signature)

Securities Count

Received intact from (insert individual's name), representative of (insert auditor's firm name), the securities listed above contained in Box .... of the (insert name of bank or custodian) which were counted by him in my presence (or presented to him for count).

Date and Time .... Signed ....

Title ....

Cutoff Bank Statement(s)

Received intact from (insert individual's name), representative of (insert auditor's firm name), the cutoff bank statements and related paid checks for the period from .... to .... (periods indicated) for the accounts listed below:

Date and Time .... Signed ....

Title ....

NOTES TO USER:

- Receipt(s) should be written and signed in *ink.*
- For counts of petty cash funds, the receipt may be written directly on the bottom of the petty cash-count working paper. For security counts and returns of cutoff bank statements, the receipt may be prepared as a separate working paper.

.09 Accounts Receivable—Positive

(Prepared on client's letterhead)

(Customer's Name)
(Address)

In connection with the audit of our financial statements, please confirm directly to our auditors (insert name and address of auditors) the amount of your indebtedness to us which according to our records as of (insert date) amounted to $______.

If the amount shown is in agreement with your records, please check "A" below.

If the amount is not in agreement with your records, please check and complete "B" below.

After checking the appropriate response, please sign and date your reply and mail it directly to our auditors in the enclosed envelope. DO NOT SEND ANY PAYMENTS to our auditors.

Very truly yours,
(Client's authorized signature)

A ____________ The balance above agrees with my records.

B ____________ My records show a balance of $________.

The difference may be due to the following:

____

____

____

____
(Signed by)

____
(Date)

.10 Accounts Receivable—Negative

(May be a sticker or stamp used on client's statements to customers)

PLEASE CHECK THIS STATEMENT

If this statement is *not correct* please write promptly (using the enclosed envelope), giving details of any differences, directly to our auditors,

(Name of auditors)

(Address of auditors)

who are now conducting an audit of our financial statements.

If you do not write to our auditors, they will consider this statement to be correct.

Remittances should NOT be sent to the auditors.

NOTES TO USER:

- A negative confirmation may also be requested in letter form using similar wording.
- The auditor should consider sending confirmation requests at the time of the client's regular monthly billings. Coordination of confirmation procedures with the client's routine preparation and mailing of statements may offer efficiency to both the auditor and client.
- Negative confirmation requests may be used as a substantive procedure to reduce audit risk *only* when three conditions exist: (1) the combined assessed level of inherent and control risk is low, (2) a large number of small balances is involved, and (3) the auditor has no reason to believe that the recipients of the request are unlikely to give them consideration.

.11 Notes Receivable

(Prepared on client's letterhead)

(Date)

(Name)
(Address)

Our auditors (insert name and address of auditors) are performing an audit of our financial statements. Accordingly, please confirm directly to our auditors the amount of your indebtedness due us as of (insert date), which our records show as follows:

Type of indebtedness ______________________________
Initial date of indebtedness ______________________________
Original amount of indebtedness ______________________________
Unpaid principal ______________________________
Interest rate ______________________________
Interest paid to ______________________________
Periodic payments required ______________________________
Description of collateral ______________________________

If the above information is in agreement with your records, please so indicate by signing in the place provided below and return the copy of this letter directly to our auditors in the enclosed envelope.

If the above is not in agreement with your records, please so note in the space provided the particulars shown in your records and any information which may help reconcile the difference from our records. **Payments should not be sent to the auditors.**

Very truly yours,

(Client's authorized signature)

The above information is correct as of (insert date) with the following exceptions (if any): ______________________________

____

____

.12 Inventories Held by Warehouses or Others When Listing Is Not Provided by Client

(Prepared on client's letterhead)

(Date)

(Name of Warehouse)
(Address)

Our auditors (insert name and address of auditors) are conducting an audit of our financial statements. Accordingly, please send directly to our auditors the following information about merchandise held in your custody for our account at (insert date):

1. Quantities on hand; for each lot please indicate the following:
   (a) Lot number (list each lot separately)
   (b) Date received
   (c) Kind of merchandise
   (d) Unit of measure or package
      (1) Number of units
      (2) Kind of units (box, can, crate, quart, pound, dozen, etc.)
2. A statement about how you determined the above requested quantities; specify whether they were determined by physical count, weight or measure, or if they represent your book record.
3. A list of negotiable or nonnegotiable warehouse receipts issued, if any, and whether or not such receipts have, to your knowledge, been assigned or pledged.
4. Statement of any known liens against this merchandise.
5. Amount of unpaid charges, if any, as of (insert date).

Please mail your reply directly to the auditors. A stamped, addressed envelope is enclosed for your convenience.

Very truly yours,
(Client's authorized signature)

.13 Inventories Held by Warehouses or Others When Listing Is Provided by Client

(Prepared on client's letterhead)

(Date)

(Name of Warehouse)
(Address)

Our auditors (insert name and address of auditors) are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the following information about the merchandise held by you for our account as of (insert date):

1. The correctness of the quantities shown on the enclosed listing of such merchandise prepared from our records (a second copy is enclosed for your files). If the enclosed listing differs from the quantities you held for us as of (insert date), please include details of the specific differences in your response to our auditors.
2. Your statement on how you determined the correctness of the quantities you are confirming; please specify whether determined by physical count, weight or measure, or whether the quantities are from your records.
3. A list of negotiable or nonnegotiable warehouse receipts issued, if any, and whether or not such receipts have, to your knowledge, been assigned or pledged.
4. Statement of any known liens against these goods.
5. Amount of any unpaid charges as of (insert date).

Please mail your reply directly to (insert name and address of auditors). A stamped, addressed envelope is enclosed for your convenience.

Very truly yours,
(Client's authorized signature)

.14

STANDARD CONFIRMATION INQUIRY FOR LIFE INSURANCE POLICIES

Developed by

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS
LIFE OFFICE MANAGEMENT ASSOCIATION
MILLION DOLLAR ROUND TABLE

ORIGINAL
To be mailed to accountant

________________19____

Dear Sirs:

Please furnish the information requested below in items 1 through 9 (and also in items 10 through 12 if any of those items are checked) for the policies identified on lines A, B and C. This information is requested as of the date indicated. IF THE ANSWER TO ANY ITEM IS "NONE," PLEASE SO STATE. The enclosed envelope is provided for the return of one copy of this form to the accountant named below.

(Ins. Co.)______________________________

____

____

(Accountant)______________________________

____

____
(Name of owner as shown on policy contracts)

Information requested as of________________

Request authorized by

____

			Col. A	Col. B
A.	Policy number			
B.	Insured			
C.	Beneficiaries as shown on policies (if verification requested in item 11) Col. A— Col. B—			
1.	Face amount of basic policy		$	$
2.	Values shown as of (insert date if other than date requested)			
3.	Premiums, including prepaid premiums, are paid to (insert date)			
4.	Policy surrender value (excluding dividends, additions and indebtedness adjustments)		$	$
5.	Surrender value of all dividend credits, including accumulations and additions		$	$
6.	Termination dividend currently available on surrender		$	$
7.	Other surrender values available to policyowner	a. Prepaid premium value	$	$
		b. Premium deposit funds	$	$
		c. Other	$	$
8.	Outstanding policy loans, excluding accrued interest		$	$
9.	If any loans exist, complete either "a" or "b" a. Interest accrued on policy loans		$	$
	b. 1.) Loan interest is paid to (enter date)			
	2.) Interest rate is (enter rate)			

The accountant will indicate by a check (✓) which if any of items 10-12 are to be answered

☐	**10.**	Is there an assignee of record? (enter Yes or No)		
☐	**11.**	Is beneficiary of record as shown in item C above? (enter Yes or No*)	*	*
☐	**12.**	Is the name of policyowner (subject to any assignment) as shown at the top of the form? (enter Yes or No) ______. If No, enter name of policyowner of record. ________________		

*If answer to 11 is No, please give name of beneficiary or date of last beneficiary change ____________

Date________________By________________________Title________________
For the insurance company addressed

Additional copies of this form are available from the American Institute of CPAs, 1211 Avenue of the Americas, New York, N. Y. 10036

STANDARD CONFIRMATION INQUIRY
FOR LIFE INSURANCE POLICIES
Developed by
AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS
LIFE OFFICE MANAGEMENT ASSOCIATION
MILLION DOLLAR ROUND TABLE

DUPLICATE
To be retained by insurance company

______________ 19____

Dear Sirs:

Please furnish the information requested below in items 1 through 9 (and also in items 10 through 12 if any of those items are checked) for the policies identified on lines A, B and C. This information is requested as of the date indicated. IF THE ANSWER TO ANY ITEM IS "NONE," PLEASE SO STATE. The enclosed envelope is provided for the return of one copy of this form to the accountant named below.

(Ins. Co.)______________________

______________________ (Name of owner as shown on policy contracts)

______________________ Information requested as of______________

(Accountant)______________________ Request authorized by

______________________ ______________________

		Col. A	Col. B
A.	Policy number		
B.	Insured		
C.	Beneficiaries as shown on policies (if verification requested in item 11) Col. A— Col. B—		
1.	Face amount of basic policy	$	$
2.	Values shown as of (insert date if other than date requested)		
3.	Premiums, including prepaid premiums, are paid to (insert date)		
4.	Policy surrender value (excluding dividends, additions and indebtedness adjustments)	$	$
5.	Surrender value of all dividend credits, including accumulations and additions	$	$
6.	Termination dividend currently available on surrender	$	$
7.	Other surrender values available to policyowner — a. Prepaid premium value	$	$
	b. Premium deposit funds	$	$
	c. Other	$	$
8.	Outstanding policy loans, excluding accrued interest	$	$
9.	If any loans exist, complete either "a" or "b" a. Interest accrued on policy loans	$	$
	b. 1.) Loan interest is paid to (enter date)		
	2.) Interest rate is (enter rate)		

The accountant will indicate by a check (✓) which if any of items 10-12 are to be answered

			Col. A	Col. B
☐	**10.**	Is there an assignee of record? (enter Yes or No)		
☐	**11.**	Is beneficiary of record as shown in item C above? (enter Yes or No*)	*	*
☐	**12.**	Is the name of policyowner (subject to any assignment) as shown at the top of the form? (enter Yes or No) ______. If No, enter name of policyowner of record. ______________________		

*If answer to 11 is No, please give name of beneficiary or date of last beneficiary change______________

Date______________By______________________Title______________
For the insurance company addressed

Additional copies of this form are available from the American Institute of CPAs, 1211 Avenue of the Americas, New York, N. Y. 10036

.15 Pension Plan Actuarial Information

(Prepared on client's letterhead)

(Date)

(Name of Actuary)
(Address)

In connection with the audit of our financial statements for the period ending (*fiscal year end*) by our independent auditors (name, address), please furnish them the information described below as it pertains to the XYZ Pension Plan, which is a defined benefit plan. For your convenience in response to those requests, you may supply pertinent sections, properly signed and dated, of your actuarial report, or pension expense report, if they are available and if they contain the requested information.

A. Please provide a brief description of the following:

1. The employee group covered.

2. The benefit provisions of the plan used in the calculation of the net periodic pension cost for the period and of the accumulated benefit obligation and the projected benefit obligation at the end of the period. Please identify any such benefit provisions that had not taken effect in the year. Please also provide the date of the most recent plan amendment included in your calculation. Please identify any participants or benefits excluded from the calculations, such as benefits guaranteed under an insurance or annuity contract.

3. The plan sponsor's funding policy for the plan.

4. Any significant liabilities other than for benefits, such as for legal or accounting fees.

5. The method and the amortization period, if any, used for the following:

   a. Calculation of a market-related value of plan assets, if different from the fair value.

   b. Amortization of any transition asset or obligation.

   c. Amortization of unrecognized prior service cost.

   d. Amortization of unrecognized net gain or loss.

6. Any substantive commitments for benefits that exceed the benefits defined by the written plan that are included in the calculations.

7. Determination of the value of any insurance or annuity contracts included in the assets.

8. Nature and effect of significant plan amendments and other significant matters affecting comparability of net periodic pension cost, funded status, and other information for the current period with that for the prior period.

9. The following information relating to the employee census data used in calculating the benefit obligations and pension cost:

   a. The source and nature of the data is ________________ and the date as of which the census data was collected is ________________.

   b. The following information concerning participants:

Participants	Number of Persons	Compensation (if applicable)
Currently receiving payments	________	________
Active with vested benefits	________	________
Terminated with deferred vested benefits	________	________
Active without vested benefits	________	________
Other (describe)	________	________

Note: If information is not available for all the above categories, please indicate the categories that have been grouped and describe any group or groups of participants excluded from the above information.

c. Information for the following individuals contained in the census:

Participants' Name or Number	Age or Birth Date	Sex	Salary	Date Hired or Years of Service

Note to Auditor: The auditor should select information from employer records to compare with the census data used by the actuary. In addition, the auditor may wish to have the actuary select certain census data from his files to compare with the employer's records.

B. Please provide the following information on the net periodic pension cost for the period ending on________ :

1. Service cost $ ________
2. Interest cost
3. Actual return on assets
4. Other components
   a. Net asset gain or (loss) during the period deferred for later recognition
   b. Amortization of net loss or (gain) from earlier periods
   c. Amortization of unrecognized prior service cost
   d. Amortization of the remaining unrecognized net obligation or (asset) existing at the date of the initial application of FASB Statement No. 87—transition obligation or (asset)
   e. Net total of components
      (a + b + c + d) ________
5. Net periodic pension cost:
   (1 + 2 − 3 + 4e) $ ________
6. The above measurement of the net periodic pension cost is based on the following assumptions:
   Weighted-average discount rate ________%
   Weighted-average rate of compensation increase ________%
   Weighted-average expected long-term rate of return on plan assets ________%
   Please describe the basis on which the above rates were selected and whether the basis is consistent with the prior period.
   Please briefly describe the other assumptions used in the above measurement.
7. The calculations of the items shown in B1 to B5 are based on the following:

Asset information at ______
Census data at ______
Measurement date (must be not more than three months before the end of the last fiscal year) ______
Please describe any adjustments made to project the census data forward to the measurement date or to project the results calculated at an earlier date to those shown in B1 to B5.

C. Please provide the following information on the benefit obligations for disclosure in the financial statements for the period ending ______:

		Estimated
1. Pension Benefit Obligation		
a. Accumulated benefit obligation		
—vested		
—non vested		______
—total	$	______
b. Additional benefits based on *estimated* future salary levels		______
c. Projected benefit obligation (a + b)		______
2. Fair Value of Plan Assets		
3. Unfunded Projected Benefit Obligation: (1c − 2)		
4. Unrecognized Prior Service Cost		
5. Unrecognized Net Loss or (Gain)		
6. Unrecognized Net Transition Liability or (Asset)		
7. Additional Liability		______
8. Accrued or (prepaid) pension cost in the company financial statements (3 − 4 − 5 − 6 + 7)	$	______

9. The above amount of the projected benefit obligation is measured based on the following assumptions:
   Weighted-average discount rate ______%
   Weighted-average rate of compensation increase ______%
   Please provide a brief description of the other assumptions used in the measurement.
10. The calculation of the items shown in C1 to C8 is based on the following:
    Asset information at ______
    Census data at ______
    Measurement date (must be not more than three months before the current fiscal year end) ______
    Please describe any adjustments made to project the census data forward to the measurement date or to project the results calculated at an earlier date to those shown in C1 to C8.
11. Please describe any significant events noted subsequent to the current year's measurement date and as of the date of your reply to this request and the effects of those events, such as a large plant closing, which could materially affect the amounts shown in C1 to C8.

D. Please provide an analysis for the period showing beginning amounts, additions, reductions, and ending amounts of the:

1. Projected benefit obligation,
2. Unrecognized prior service cost,
3. Unrecognized net loss (gain), and
4. Net transition obligation (asset).

E. Please provide our independent auditors with descriptions and the amounts of gains or losses from settlements, curtailments or termination benefits during the year, such as:

1. Purchases of annuity contracts,

2. Lump-sum cash payments to plan participants,
3. Other irrevocable actions that relieved the company or the plan of primary responsibility for a pension obligation, and eliminates significant risks related to the obligation and assets,
4. Any events that significantly reduced the expected years of future service of employees,
5. Any events that eliminated for a significant number of employees the accrual of defined benefits for some or all of their future service, or
6. Any special or contractual termination benefits offered to employees.

F. Was all of the information above determined in accordance with FASB Statements No. 87 and No. 88 (including the FASB's Guides to Implementation of Statements 87 and 88 and the American Academy of Actuaries', "An Actuary's Guide to Compliance with Statement of Financial Accounting Standards No. 87") to the best of your knowledge? If not, please describe any differences.

G. Describe the nature of your relationship, if any, with the plan or the plan sponsor that may impair or appear to impair the objectivity of your work.

Very truly yours,

____

.16 Pension Plan Assets Held by Trustee

(Prepared on client's letterhead)

(Date)

(Name of trustee or custodian)
(Address)

Our auditors (insert name and address of auditor) are conducting an audit of our financial statements. Accordingly, please provide our auditors directly with a listing of the assets including market values as of (insert date) for our employees' pension trust (insert title and trustee's account number).

Please also provide the auditors with the following information about our employees' pension trust for the period from (insert date) to (insert date) [see note below]:

1. Contributions by the Company during the above period.
2. Contributions by employees during the above period.
3. Payments to beneficiaries during the above period.
4. Any unpaid fees due for services rendered to (insert audit date).

Please send your reply directly to our auditors. A stamped, addressed envelope is enclosed for your convenience.

Very truly yours,
(Client's authorized signature)

NOTE TO USER:

A listing of the assets might not be requested if one had already been received by the client. In that case, the auditor might want the trustee to confirm the total market value per the listing.

.17 Actuary of a PERS for Disclosure in Financial Reports Incorporating the PERS' Financial Statements and/or Actuary of a Single-Employer PERS or an Agent Multiple-Employer PERS for Disclosure in the Financial Reports of a Contributing Governmental Employer or Nonemployer Contributor That Does Not Include the PERS in Its Reporting Entity *

(Prepared on PERS or contributing governmental employer or nonemployer contributor letterhead)

(Name of Actuary of PERS)
(Address) Date

Dear ——————————:

In connection with the audit of our financial statements for the period ending (fiscal year end) by our independent auditors, (name and address of independent auditors), please furnish directly to them the information described below as it relates to the (name of PERS) and the participation therein of employees of the (name of governmental employer). Also, please provide a copy of the most recent actuarial valuation report.

For your convenience in response to these requests, you may supply pertinent sections, properly signed and dated, of your actuarial report, or pension expense report, if they are available and if they contain the requested information.

If any figures presented herein are estimates, please so indicate and briefly describe the estimation technique used.

A. Please provide a brief description of the following:

1. Types of employees covered and current membership with separate identification of the number of (a) retirees and beneficiaries currently receiving benefits, and terminated employees entitled to benefits but not yet receiving them and (b) full vested, partially vested, and nonvested active employees covered by the plan.

2. If agent or cost-sharing multiple-employer PERS, (name of governmental employer) current-year covered payroll.

B. Please provide, for each of the following participants, the indicated information relating to the employee census data used in performing the actuarial valuation(s) described in C1 and E2. Also, please identify the source, nature, and date as of which the census data was collected.

Participant's Name or Number	Age or Birth Date	Sex	Salary	Date Hired or Years of Service

(*Note to auditor*—Select sample participants from records and list them here.)

C. Please indicate, with respect to the actuarial present value of credited projected benefits (hereinafter referred to as the APV of CPB or "pension benefit obligation")

1. Date of the most recent actuarial valuation in which the APV of CPB was calculated and the date of any subsequent actuarial update.

2. Significant actuarial assumptions used to compute the APV of CPB, including rate of return on investment of present and future assets, projected salary increases due to (a) inflation and (b) merit or seniority, and postretirement benefit increases.

* Disclosures are required pursuant to GASB *Codification of Governmental Accounting and Financial Reporting Standards,* paragraphs Pe6.130—.132, P20.123—.127, and .131, as of June 15, 1987.

3. Amount of the entire APV of CPB, for the entire PERS, in total and segregated as follows:

    a. Retirees and beneficiaries currently receiving benefits and terminated employees entitled to benefits but not yet receiving them.

    b. Current employees:

        i. Accumulated employee contributions including allocated investment income, if any.

        ii. Employer-financed vested.

        iii. Employer-financed nonvested.

4. If agent multiple-employer PERS, amount of the APV of CPB applicable to (name of governmental employer) participants, in total and segregated as follows:

    a. Retirees and beneficiaries currently receiving benefits and terminated employees entitled to benefits but not yet receiving them. (If the pension benefit obligation applicable to retirees and beneficiaries currently receiving benefits, and related net assets available for benefits, are transferred to the PERS as a whole, please state that fact and provide here only the APV of CPB applicable to terminated employees entitled to benefits but not yet receiving them, and related net assets available for benefits.)

    b. Current employees:

        i. Accumulated employee contributions including allocated investment income, if any.

        ii. Employer-financed vested.

        iii. Employer-financed nonvested.

5. Net assets available for benefits as of the same date as the pension benefit obligation determined in accordance with the method used to value assets for balance sheet purposes; also identify the method used to value assets.

6. Explanation, including separate dollar effects on the APV of CPB described in C3 and C4, of any current-year changes in (a) actuarial assumptions or (b) benefit provisions.

D. Please indicate, with respect to plan assets:

1. Market value of the entire net assets available for benefits, for the entire PERS, on the same date as the APV of CPB.

2. Amortized cost value of the entire net assets available for benefits, for the entire PERS, on the same date as the APV of CPB, with disclosure of the method used to account for exchanges of "swaps" of securities.**

3. If agent or cost-sharing multiple-employer PERS that is included in the employer's reporting entity, market value of net assets available for benefits applicable to (name of governmental employer) participants on the same date as the APV of CPB. (Do not include net assets available for benefits applicable to retirees and beneficiaries currently receiving benefits, if the pension benefit obligation applicable to them is transferred to the PERS as a whole.)

** Information on amortized cost values and the method used to account for exchanges or "swaps" of securities need be obtained only if the plan is accounted for in accordance with the requirements of National Council on Governmental Accounting Statements Nos. 1, *Governmental Accounting and Financial Reporting Principles,* or 6, *Pension Accounting and Financial Reporting: Public Employee Retirement Systems, and State and Local Government Employers,* as permitted by GASB Statement No. 5, *Disclosure of Pension Information by Public Employee Retirement Systems and State and Local Governmental Employers,* paragraph 4.

4. If agent or cost-sharing multiple-employer PERS that is included in the employer's reporting entity, amortized cost value of net assets available for benefits applicable to (name of governmental employer) participants on the same date as the APV of CPB, with disclosures of the method used to account for exchanges or "swaps" of securities.*** (Do not include net assets available for benefits applicable to retirees and beneficiaries currently receiving benefits, if the pension benefit obligation applicable to them is transferred to the PERS as a whole.)

E. Please indicate, with respect to contributions required and contributions made:

1. A brief description of funding policy, including the role of actuarially determined contribution requirements in carrying out that policy.

2. Date of the most recent actuarial valuation performed to compute actuarially determined contribution requirements.

3. Actuarial funding method used to compute actuarially determined contribution requirements and the period and method for amortization of any unfunded actuarial accrued liability.

4. That significant actuarial assumptions used to compute actuarially determined contribution requirements are the same as those used to compute the APV or CPB, or explain the differences.

5. Total actuarially determined contribution requirement for the entire PERS, and the amounts intended to (a) cover normal cost and (b) amortize any unfunded actuarial accrued liability, expressed in dollar amounts and as percentages of current-year covered payroll.

6. Total contributions actually made for the entire PERS by (a) contributing governmental employers or nonemployer contributors and (b) employees, expressed in dollar amounts and as percentages of current-year covered payroll.

7. If agent or cost-sharing multiple-employer PERS that is included in employer's reporting entity, actuarially determined contribution requirements applicable to (name of governmental employer) participants and the amounts intended to (a) cover normal cost and (b) amortize any unfunded actuarial accrued liability, expressed both in dollar amounts and as percentages of current-year covered payroll.

8. If agent or cost-sharing multiple-employer PERS that is included in employer's reporting entity, contributions actually made, applicable to (name of governmental employer) participants, by (name of contributing governmental employer or nonemployer contributor) and by (name of governmental employer) employees, expressed both in dollar amounts and as percentages of current-year covered payroll.

9. Explanations, including the separate dollar effects on the actuarially determined contribution requirements described in E5, E6, E7, and E8 of any current-year changes in (a) actuarial assumptions (b) benefit provisions, (c) actuarial funding method, or (d) other significant factors.

F. Please describe any significant events noted, subsequent to the dates described in C1 and E2 and as of the date of your response to this request, that could materially affect (the auditor should indicate the amount considered material) the information described in A to E. Also describe the effects of those events.

G. Please indicate that the information you provide has been determined in accordance with the provisions of GASB Statement No. 5, or explain any exceptions.

*** Information on amortized cost values and the method used to account for exchanges or "swaps" of securities need be obtained only if the plan is accounted for in accordance with the requirements of National Council on Governmental Accounting Statements Nos. 1, *Governmental Accounting and Financial Reporting Principles*, or 6, *Pension Accounting and Financial Reporting: Public Employee Retirement Systems, and State and Local Government Employers*, as permitted by GASB Statement No. 5, *Disclosure of Pension Information by Public Employee Retirement Systems and State and Local Governmental Employers*, paragraph 4.

H. Please describe the nature of any relationship you have with the (name of PERS) or (name of contributing governmental employer or nonemployer contributor) that may impair, or appear to impair, the independence and objectivity of your work.

I. Please advise if notification has been received of a decision to partially or fully terminate the plan and explain the effect of the decision.

J. Please provide any additional information you consider necessary.

Very truly yours,

(Name of Contributing Governmental Employer or
Nonemployer Contributor)

By (Name and Title of Requesting Official of Contributing Governmental Employer or Nonemployer Contributor)

.18 Actuary of a Cost-Sharing Multiple-Employer PERS, for Disclosure in Financial Reports of a Contributing Governmental Employer or Nonemployer Contributor That Does Not Include the Cost-Sharing Multiple-Employer PERS in Its Reporting Entity*

(Prepared on contributing governmental employer or nonemployer contributor letterhead)

(Name of actuary of PERS)
(Address) Date

In connection with the audit of our financial statements for the period ending (fiscal year end) by our independent auditors, (name and address of independent auditors), please furnish directly to them the information described below as it relates to the participation of employees of the (name of governmental employer) in the (name of PERS). Also, please provide a copy of the most recent actuarial valuation report.

For your convenience in response to these requests, you may supply pertinent sections, properly signed and dated, of your actuarial report, or pension expense report, if they are available and if they contain the requested information.

If any figures presented herein are estimates, please so indicate and briefly describe the estimation technique used.

Please provide the following:

A. (Name of governmental employer) current-year covered payroll.

B. For each of the following participants, the indicated information relating to the employee census data used in performing the actuarial valuation(s) in which the amounts described in C and G were computed.

Participant's Name or Number	Age or Birth Date	Sex	Salary	Date Hired or Years of Service

(*Note to auditor*—Select sample participants from records and list them here.)

C. Actuarially determined contribution requirement applicable to (name of governmental employer) participants, expressed both in a dollar amount and as a percentage of current-year covered payroll. Also, describe any current-year changes in actuarial assumptions, benefit provisions, actuarial funding method, or other significant factors, and the aggregate effect on the actuarially determined contribution requirement applicable to (name of governmental employer) participants, expressed as a percentage of current-year covered payroll.

D. The total PERS actuarial present value of credited projected benefits (APV of CPB).

E. Market value of the total PERS net assets available for benefits (as of the same date as the APV of CPB).

F. Amortized cost value of the total PERS net assets available for benefits (as of the same date as the APV of CPB).**

* Disclosures are required pursuant to GASB *Codification of Governmental Accounting and Financial Reporting Standards,* paragraph P20.127, as of June 15, 1987.

** Information on amortized cost values need be obtained only if the plan is accounted for in accordance with the requirements of National Council on Governmental Accounting Statements Nos. 1, *Governmental Accounting and Financial Reporting Principles,* or 6, *Pension Accounting and Financial Reporting: Public Employee Retirement Systems, and State and Local Government Employers,* as permitted by GASB Statement No. 5, *Disclosure of Pension Information by Public Employee Retirement Systems and State and Local Governmental Employers,* paragraph 4.

G. The actuarially determined contribution requirement applicable to (name of governmental employer) participants, expressed as a percentage of the total current-year actuarially determined contribution requirement for the PERS as a whole.

H. Please indicate that the information you provide has been determined in accordance with the provisions of GASB Statement No. 5, or explain any exceptions.

I. Please describe the nature of any relationship you have with the (name of PERS) or (name of contributing governmental employer or nonemployer contributor) that may impair, or appear to impair, the independence and objectivity of your work.

J. Please provide information relating to subsequent events that could affect the information provided herein.

K. Please advise if notification has been received of a decision to partially or fully terminate the plan and explain the effect of the decision.

L. Please provide any additional information you consider necessary.

Very truly yours,

(Name of Contributing Governmental Employer or
Nonemployer Contributor)

By (Name and Title of Requesting Official of Contributing Governmental Employer or Nonemployer Contributor)

.19 Notes Payable

(Prepared on client's letterhead)

(Date)

(Name)
(Address)

Our auditors (insert name and address) are conducting an audit of our financial statements.

Accordingly, please confirm directly to them the following information relating to our note(s) payable to you, as of (insert date):

Date of Note: (insert date)

Original Amount: (insert amount)

Unpaid Principal

Balance: (insert amount)

Periodic payments required

Payment periods

Maturity Date: (insert date)

Interest Rate: (insert rate)

Date to which interest has been paid: (insert date)

Amount and description of collateral: (insert description)

Description of terms, e.g., demand provisions, prepayment penalties, etc.

Any other direct or contingent liabilities to you: (insert "None" or description)

If the above information is in agreement with your records at that date, please so indicate by signing in the place provided below and return the copy of this letter directly to our auditors in the enclosed envelope.

If the above is not in agreement with your records, please note in the space provided the particulars shown in your records and any information which may help reconcile the difference from our records.

Very truly yours,

(Client's authorized signature)

The above information is correct as of (insert date) with the following exceptions (if any):......................

....

Date .... Signature ....

Title ....

.20 Mortgage Debt

(Prepared on client's letterhead)

(Date)

(Name of creditor or trustee)
(Address)

Our auditors (insert name and address of auditors) are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the following information about our mortgage indebtedness to you as of (insert date):

1. Original amount.
2. Date of note.
3. Unpaid principal balance.
4. Interest rate.
5. Terms for payment of principal.
6. Date to which interest has been paid.
7. Nature of mortgage and description or address of property mortgaged.
8. Amounts on deposit with you in escrow for:
    a. Insurance
    b. Real estate taxes
9. Amounts paid during the period (insert dates from and to) for:
    a. Insurance
    b. Taxes
10. Amounts on deposit with you for the "reserve for repairs."
11. The nature of defaults, if any.
12. Description of terms, e.g., prepayment penalties, demand provisions, etc.

A return envelope is enclosed for your reply.

Very truly yours,
(Client's authorized signature)

NOTE TO USER:

Many of the items requested will vary with the circumstances of the particular mortgage or other debt involved. The above sample assumes the indenture involves an escrow arrangement for insurance and real estate taxes and a deposit account for repairs.

.21 Accounts Payable

(Prepared on client's letterhead)

(Date)

(Name)
(Address)

In connection with the audit of our financial statements, please confirm directly to our auditors (insert name and address of auditors), the amount of our liability to you as of (insert date). Please attach a statement of our account due. If no balance is due, please attach a statement of our account showing payments made.

Please mail your reply directly to (name of auditors). A stamped, addressed envelope is enclosed for your convenience.

Very truly yours,
(Client's authorized signature)

Our records indicate that a balance of $.......... was due from (insert name of client) at (insert date).

Date.............................

Signed ....
Title ....

.22 Obligation to Lessor

(Prepared on client's letterhead)

(Date)

(Name of lessor)
(Address)

Our auditors (insert name and address of auditors) are conducting an audit of our financial statements as of (insert balance sheet date) and for the (insert time period) then ended. In connection with this audit, please provide directly to our auditors the following information as of (insert balance sheet date) regarding the lease dated (insert date lease was executed) of (insert brief identification of property under lease) which we are leasing from you:

1. Inception and expiration dates for the lease period, from .... to ....
2. Amount of monthly rent ....
3. Renewal options (if any):
   a. Dates of renewal period, from .... to ....
   b. Amount of monthly rent for renewal ....
4. Purchase options (if any):
   a. Amount of purchase price ....
   b. Inception and expiration dates of option, from .... to ....
   c. Percent of monthly rent (if any) applicable towards purchase price ....
5. Dates and descriptions of amendments or supplementary understandings, if any, to the lease mentioned above.
6. The amount of outstanding delinquent payments, if any.
7. A statement that there are no defaults, or the nature of defaults, if any.

A return envelope is enclosed for your reply.

Very truly yours,

(Client's authorized signature)

NOTE TO USER:

The content of this type of letter will vary based on the auditor's professional judgment in the circumstances. To provide additional illustrative language, the above letter is not made parallel with the illustration at AAM section 7200.23.

.23 Property Out on Lease

(Prepared on client's letterhead)

(Date)

(Name of Lessee)
(Address)

Our auditors (insert name and address of auditors) are conducting an audit of our financial statements as of (insert balance sheet date) and for the (insert time period) then ended. In connection with this audit, please confirm directly to our auditors the following information regarding the lease dated (insert execution date of lease) of (insert brief identification of property under lease) which you are leasing from us:

1. Inception and expiration dates of lease period from .... to ....
2. Amount of monthly rent ....
3. Total rental payments made ....
4. Date of last payment ....

A return envelope is enclosed for your reply.

Very truly yours,
(Client's authorized signature)

NOTES TO USER:

- If the leased property is of a mobile or portable nature such as a bulldozer or television camera, the confirmation may also include a request for specific serial numbers of significant equipment.
- In certain circumstances, the auditor may wish to consider confirming additional information such as renewal options, purchase options, and amendments or supplementary understandings.

.24 Registrar—Capital Stock

(Prepared on client's letterhead)

(Date)

(Name of Registrar)
(Address)

Our auditors (insert name and address of auditors) are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the following information as of the close of business (insert balance sheet date) about each class of our preferred and common stock:

1. Authorized number of shares
2. Issued number of shares
3. Outstanding number of shares

Please also indicate the amount of any unpaid registrar fees due you as of (insert balance sheet date).

A return envelope is enclosed for your convenience.

Very truly yours,
(Authorized signature for client)

NOTES TO USER:

- It may be helpful to include the registrar's account number for the client's account to receive a timely response.
- Some auditors prefer that the confirmation request include identification of each class of stock.
- The above illustration assumes the client has a separate transfer agent (see AAM section 7200.25).

.25 Transfer Agent—Capital Stock

(Prepared on client's letterhead)

(Date)

(Name of Transfer Agent)
(Address)

Our auditors (insert name and address of auditors) are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the following information as of (insert balance sheet date) about each class of our preferred and common stock:

1. Authorized number of shares
2. Number of shares issued and outstanding
3. Number of outstanding shares registered in the name of our Company.

Please also indicate the amount of any unpaid transfer agent fees due you as of (insert balance sheet date).

A return envelope is enclosed for your convenience.

Very truly yours,
(Authorized signature for client)

NOTES TO USER:

- It may be helpful to include the transfer agent's account number for the client's account to receive a timely response.
- Some auditors prefer that the confirmation request include identification of each class of stock.
- Depending on the auditor's judgment in the circumstances the confirmation request may also include inquiries about such matters as (i) the number of shares issued to each of specifically mentioned officers and directors, (ii) specified information about shareholders owning more than a stated percent of the total outstanding shares, and (iii) amounts deposited during the year for the payment of dividends.

.26 Request for Confirmation of Money Market Fund

(Prepared on client's letterhead)

(Date)

(Name)

(Address)

Our auditors, (insert name and address of auditors) are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the balance of our money market fund account(s) as of (insert date).

Please indicate in the space provided below the account number(s) and balance(s) of our account(s) per your records.

Please sign and date your reply and return it directly to the auditors. A stamped, self-addressed envelope is enclosed for your convenience.

Very truly yours,
(Client's authorized signature)

Account No.	*Date*	*Balance*
....	....	....
....	....	....
....	....	....

Date: .... Signed: ....

.27 Confirmation of Contingent Liabilities

(Date)

Financial Institution Official *
First United Bank
Anytown, USA 00000

Dear Financial Institution Official:

In connection with an audit of the financial statements of (name of customer) as of (balance-sheet date) and for the (period) then ended, we have advised our independent auditors of the information listed below, which we believe is a complete and accurate description of our contingent liabilities, including oral and written guarantees, with your financial institution. Although we do not request nor expect you to conduct a comprehensive, detailed search of your records, if during the process of completing this confirmation additional information about other contingent liabilities, including oral and written guarantees, between (name of customer) and your financial institution comes to your attention, please include such information below.

Name of Maker	Date of Note	Due Date	Current Balance

Interest Rate	Date Through Which Interest Is Paid	Description of Collateral	Description of Purpose of Note

Information related to oral and written guarantees is as follows:

____
____
____
____

Please confirm whether the information about contingent liabilities presented above is correct by signing below and returning this directly to our independent auditors (name and address of CPA firm).

Sincerely,

(Name of Customer)

____

By: ______________________________
(Authorized Signature)

* This letter should be addressed to a financial institution official who is responsible for the financial institution's relationship with the client or is knowledgeable about the transactions or arrangements. Some official institutions centralize this function by assigning responsibility for responding to confirmation requests to a separate function. Independent auditors should ascertain the appropriate recipient.

Dear CPA Firm:

The above information listing contingent liabilities, including oral and written guarantees, agrees with the records of this financial institution.* Although we have not conducted a comprehensive, detailed search of our records, no information about other contingent liabilities, including oral and written guarantees, came to our attention. [Note exceptions below or in an attached letter.]

____

____

____

____

____

____
(Name of Financial Institution)

By: ________________________ __________
(Officer and Title) (Date)

* If applicable, comments similar to the following may be added to the confirmation reply by the financial institution: This confirmation does not relate to arrangements, if any, with other branches or affiliates of this financial institution. Information should be sought separately from such branches or affiliates with which any such arrangements might exist.

.28 Confirmation of Compensating Balances

(Date)

Financial Institution Official*
First United Bank
Anytown, USA 00000

Dear Financial Institution Official:

In connection with an audit of the financial statements of (name of customer) as of (balance-sheet date) and for the (period) then ended, we have advised our independent auditors that as of the close of business on (balance-sheet date) there (were) (were not) compensating balance arrangements as described in our agreement dated (date). Although we do not request nor expect you to conduct a comprehensive, detailed search of your records, if during the process of completing this confirmation additional information about other compensating balance arrangements between (name of customer) and your financial institution comes to your attention, please include such information below. Withdrawal by (name of customer) of the compensating balance (was) (was not) legally restricted at (date). The terms of the compensating balance arrangements at (date) were:

EXAMPLES:

1. The Company has been expected to maintain an average compensating balance of 20 percent of its average loan outstanding, as determined from the financial institution's ledger records adjusted for estimated average uncollected funds.
2. The Company has been expected to maintain an average compensating balance of $100,000 during the year, as determined from the financial institution's ledger records without adjustment for uncollected funds.
3. The Company has been expected to maintain a compensating balance, as determined from the financial institution's ledger records without adjustment for uncollected funds, of 15 percent of its outstanding loans plus 10 percent of its unused line of credit.
4. The Company has been expected to maintain as a compensating balance noninterest bearing time deposits of 10 percent of its outstanding loans.

In determining compliance with compensating balance arrangements, the Company uses a factor for uncollected funds of ____ (business) (calendar) days.[1]

There (were the following) (were no) changes in the compensating balance arrangements during the (period) and subsequently through the date of this letter.

The Company (was) (was not) in compliance with the compensating balance arrangements during the (period) and subsequently through the date of this letter.

* This letter should be addressed to a financial institution official who is responsible for the financial institution's relationship with the client or is knowledgeable about the compensating balance arrangements. Some financial institutions centralize this function by assigning responsibility for responding to confirmation requests to a separate function. Independent auditors should ascertain the appropriate recipient.

[1] Not applicable if compensating balances are based on the financial institution's ledger records without adjustment for uncollected funds. If some other method is used for determining collected funds for compensating balance purposes, the method used should be described.

There (were the following) (were no) sanctions (applied or imminent) by the financial institution because of noncompliance with compensating balance arrangements.[2]

During the (period), and subsequently through the date of this letter, (no) (the following) compensating balances were maintained by the Company at the financial institution on behalf of an affiliate, director, officer, or any other third party and (no) (the following) third party maintained compensating balances at the bank on behalf of the Company. (Withdrawal of such compensating balances (was) (was not) legally restricted.)

Please confirm whether the information about compensating balances presented above is correct by signing below, and returning this letter directly to our independent auditors (name and address of CPA Firm).

Sincerely,

(Name of customer)

____

By: ______________________________

(Authorized Signature)

Dear CPA Firm:

The above information regarding the compensating balance arrangements with this financial institution agrees with the records of this financial institution.* Although we have not conducted a comprehensive, detailed search of our records, no information about other compensating balance arrangements, came to our attention. [Note exceptions below or in an attached letter.]

____

____

____

____

____

(Name of Financial Institution)

By: ____________________ __________

(Officer and Title) (Date)

---

[2] Applicable only if the financial institution has applied sanctions during the (period) or notified the Company that sanctions may be applied. Indicate details.

* If applicable, comments similar to the following may be added to the confirmation reply by the financial institution: This confirmation does not relate to arrangements, if any, with other branches or affiliates of this financial institution. Information should be sought separately from such branches or affiliates with which any such arrangements might exist.

.29 Confirmation of Lines of Credit

(Date)

Financial Institution Official *
First United Bank
Anytown, USA 00000

Dear Financial Institution Official:

In connection with an audit of the financial statements of (name of customer) as of (balance-sheet date) and for the (period) then ended, we have advised our independent auditors of the information listed below, which we believe is a complete and accurate description of our line of credit from your financial institution as of the close of business on (balance-sheet date). Although we do not request nor expect you to conduct a comprehensive, detailed search of your records, if during the process of completing this confirmation additional information about other lines of credit from your financial institution comes to your attention, please include such information below.

The Company has available at the financial institution a line of credit totaling (amount). The current terms of the line of credit are contained in the letter dated (date). The related debt outstanding at the close of business on (date) was $(amount).

The amount of unused line of credit, subject to the terms of the related letter, at (date) was $(amount).

Interest rate at the close of business on (date) was ____%.
Compensating balance arrangements are ____

____

____

____

This line of credit supports commercial paper (or other borrowing arrangements) as described below:

____

____

____

* This letter should be addressed to a financial institution official who is responsible for the financial institution's relationship with the client or is knowledgeable about the lines of credit. Some financial institutions centralize this function by assigning responsibility for responding to confirmation requests to a separate function. Independent auditors should ascertain the appropriate recipient.

Please confirm whether the information about lines of credit presented above is correct by signing below and returning this letter directly to our independent auditors (name and address of CPA Firm).

Sincerely,

(Name of customer)

____

By: ______________________________
(Authorized Signature)

Dear CPA Firm:

The above information regarding the line of credit arrangements agrees with the records of this financial institution.* Although we have not conducted a comprehensive, detailed search of our records, no information about other lines of credit came to our attention. [Note exceptions below or in an attached letter.]

____

____

____

____

____
(Name of Financial Institution)

By: ______________________________ ______________
(Officer and Title) (Date)

* If applicable, comments similar to the following may be added to the confirmation reply by the financial institution: This confirmation does not relate to arrangements, if any, with other branches or affiliates of this financial institution. Information should be sought separately from such branches or affiliates with which any such arrangements might exist.

.30 Related-Party Confirmation

(Date)

(Name)

(Address)

In connection with an audit of our financial statements, please furnish answers to the attached questionnaire, sign your name, and return the questionnaire in the enclosed envelope directly to our auditors (firm name). The questionnaire is designed to provide the auditors with information about the interests of officers, directors, and other related parties in transactions with our Company.

Please answer all questions. If the answer to any question is "yes," please explain. Certain terms used in the questions are defined at the end of the questionnaire.

Very truly yours,

____
(Name)

____
(Title)

(Client Name)

Related-Party Questionnaire

1. Have you or any related-party of yours had any material interest, direct or indirect, in any sales, purchases, transfers, leasing arrangements or guarantees or other transactions since (beginning of period of audit) to which the Company (or specify any pension, retirement, savings, or similar plan provided by the client) was, or is to be, a party?

2. Do you or any related-party of yours have any material interest, direct or indirect, in any pending or incomplete sales, purchases, transfers, leasing arrangements, guarantees or other transactions to which the Company (or specify any pension, retirement, savings, or similar plan provided by the client) was, or is to be, a party?

3. Have you or any related-party of yours been indebted to the Company (or specify any pension, retirement, savings, or similar plan provided by the client) at any time since (beginning of period of audit)? Please exclude amounts due for purchases on usual trade terms and for ordinary travel and expense advances.

The answers to the foregoing questions are correctly stated to the best of my knowledge and belief.

_______________________ _______________________

(Date) (Signature)

See definitions at end of questionnaire.

Definitions

Company: Parent company and any subsidiary.

Related Party: Any (1) corporation or organization (other than the Company) of which you are an officer, director, or partner or are, directly or indirectly, the beneficial owner of 10 percent or more of any class of equity securities; (2) any trust or other estate in which you have a substantial beneficial ownership or for which you serve as trustee or in a similar fiduciary capacity; and (3) any close relative of yours or your spouse's, or other person you may significantly influence (control) or be significantly influenced by.

Control: possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a party, whether through ownership, by contract, or otherwise.

Person: an individual, a corporation, a partnership, an association, a joint-stock company, a business trust, or an unincorporated organization.

Beneficial Owner: a person who enjoys, or has the right to secure, benefits substantially equivalent to those of the ownership of securities, even though the securities are not registered in the person's name. Examples of beneficial ownership include securities held for the person's benefit in the name of others, such as nominees, custodians, brokers, trustees, executors and other fiduciaries; a partnership of which the person is a partner; and a corporation for which the person owns substantially all of the stock. Shares (1) held (individually or in a fiduciary capacity) by the person's spouse, the person's or his or her spouse's minor children, or a relative of the person or his or her spouse who shares the same home with the person; or (2) as to which the person can vest or revest title in himself at once or at some future time are also considered as being beneficially owned.

.31 Safe Deposit Box Access Confirmation

[*Date*]

____
____
____

Our auditors, ____________________ [*name and address of auditors*], are conducting an audit of our financial statements. Accordingly, please confirm there has been no access to our safe deposit box number ____ between ____ and ____ o'clock.

Please indicate in the space below if the above is in agreement with your records. If it is not, please furnish the auditors any details concerning access to our safe deposit box during the period indicated.

After signing and dating your reply, please mail it directly to our auditors in the enclosed envelope.

Very truly yours,

____

[*Client's Authorized Signature*]

According to our records, there has been no access to the above described safe deposit box during the period specified, except as follows: ____

____

Signed:______________________________ Date: ________________________

[*Name and Title*]

.32 Insurance In Force Confirmation Request

[*Date*]

____
____
____

Our auditors, __________ [*name and address of auditors*], are conducting an audit of our financial statements. In that connection, please confirm the details of our insurance coverage in force at __________ [*balance-sheet date*] as described below:

Policy number	________	________
Insurance company	________	________
Type of coverage	________	________
Amount of coverage	________	________
Co-insurance, if any	________	________
Term of policy	________	________
Gross premium	________	________
Amount of unpaid premiums	________	________
Loss payees, if other than us	________	________
Claims pending at ________ [*date*]	________	________

Please compare this information with your records and inform our auditors, in the space below, if it is, or is not, in agreement with your records. After signing and dating your reply, please mail it directly to our auditors in the enclosed envelope.

Very truly yours,

____

[*Client's Authorized Signature*]

The above information agrees with our records at __________ [*balance-sheet date*] with the following exceptions:

____
____
____
____

Signed:________________________ Date: ________________

[*Name and Title*]

[The next page is 7301.]

AAM Section 7300
Inquiries to Legal Counsel[1]

.01 Illustrative Inquiry Letter to Legal Counsel[2]

(Prepared on client's letterhead—See Note A)

Date (See Note B)

(Name of lawyer)
(Address of lawyer)

Dear ....:

In connection with an audit of our financial statements at (balance sheet date) and for the (period) then ended, management of the Company has prepared, and furnished to our auditors (name and address of auditors), a description and evaluation of certain contingencies, including those set forth below involving matters with respect to which you have been engaged and to which you have devoted substantive attention on behalf of the Company in the form of legal consultation or representation. These contingencies are regarded by management of the Company as material for this purpose (management may indicate a materiality limit if an understanding has been reached with the auditor). Your response should include matters that existed at (balance sheet date) and during the period from that date to the date of your response.

Pending or Threatened Litigation

(excluding unasserted claims)

> [Ordinarily the information would include the following: (1) the nature of the litigation, (2) the progress of the case to date, (3) how management is responding or intends to respond to the litigation (for example, to contest the case vigorously or to seek an out-of-court settlement), and (4) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.]

Please furnish to our auditors such explanation, if any, that you consider necessary to supplement the foregoing information, including an explanation of those matters as to which your views may differ from those stated and an identification of the omission of any pending or threatened litigation, claims, and assessments or a statement that the list of such matters is complete.

Unasserted Claims and Assessments

(considered by management to be probable of assertion, and that, if asserted, would have at least a reasonable possibility of an unfavorable outcome)

> [Ordinarily management's information would include the following: (1) the nature of the matter, (2) how management intends to respond if the claim is asserted, and (3) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.]

---

[1] If a client has not needed to retain legal counsel, the auditor may express an unqualified opinion on the financial statements even though he has not obtained a letter from legal counsel of the Company. In these circumstances, the auditor should obtain written representation from the Company that legal counsel has not been retained for matters concerning business operations that may involve current or prospective litigation (see AICPA **Technical Practice Aids**, section 8340.10).

[2] Extracted from the Appendix to Statement on Auditing Standards No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* [AU section 337A]. [See Note B.]

Please furnish to our auditors such explanation, if any, that you consider necessary to supplement the foregoing information, including an explanation of those matters as to which your views may differ from those stated.

We understand that whenever, in the course of performing legal services for us with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, if you have formed a professional conclusion that we should disclose or consider disclosure concerning such possible claim or assessment, as a matter of professional responsibility to us, you will so advise us and will consult with us concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5. Please specifically confirm to our auditors that our understanding is correct.

Please specifically identify the nature of and reasons for any limitation on your response.

> [The auditor may request the client to inquire about additional matters, for example, unpaid or unbilled charges or specified information on certain contractually assumed obligations of the company, such as guarantees of indebtedness of others.]

Very truly yours,

(Authorized signature for client)

NOTES TO USER:

(A) Auditors should carefully consider the provisions of SAS No. 12 [AU section 337] in drafting this letter.

(B) Sending of this letter should be timed so that the lawyer's response is dated as close to the auditor's opinion date as practicable. However, the auditor and client should consider early mailing of a draft inquiry as a convenience for the lawyer in preparing a timely response to the formal inquiry letter.

.02 Illustrative Inquiry Letter to Legal Counsel If Management Has Not Provided Details About Pending or Threatened Litigation

(Prepared on client's letterhead—See Note A)

Date (See Note B)

(Name of lawyer)
(Address of lawyer)

Dear ....:

In connection with an audit of our financial statements at (balance sheet date) and for the (period) then ended, please furnish to our auditors (name and address of auditors), the information requested below with respect to which you have been engaged and to which you have devoted substantive attention on behalf of the Company in the form of legal consultation or representation. Your response should include matters that existed at (balance sheet date) and during the period from that date to the date of your response.

Pending or Threatened Litigation

(excluding unasserted claims)

Please prepare a description of all litigation, claims, and assessments (excluding unasserted claims and assessments) involving amounts exceeding (amount) individually or lesser amounts that exceed (amount) in the aggregate. The description of each case should include—

1. The nature of the litigation.
2. The progress of the case to date.
3. How management is responding or intends to respond to the litigation (e.g., to contest the case vigorously or to seek an out-of-court settlement).
4. An evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.

Unasserted Claims and Assessments

We understand that whenever, in the course of performing legal services for us with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, you have formed a professional conclusion that we should disclose or consider disclosure concerning such possible claim or assessment, you will so advise us and will consult with us concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5, as a matter of professional responsibility to us. *Please specifically confirm to our auditors that our understanding is correct.*

We have represented to our auditors that you have not advised us of any unasserted claims or assessments that are probable of assertion and must be disclosed in accordance with Statement of Financial Accounting Standards No. 5.

Other Matters

1. Please specifically identify the nature of and reasons for any limitation on your response.
2. Please indicate the amount owed to you for services and expenses (billed and unbilled) at (balance sheet date).

Very truly yours,

(Authorized signature for client)

NOTES TO USER:

(A) Auditors should carefully consider the provisions of SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* [AU section 337] in drafting this letter.

(B) Sending of this letter should be timed so that the lawyer's response is dated as close to the auditor's opinion date as practicable. However, the auditor and client should consider early mailing of a draft inquiry as a convenience for the lawyer in preparing a timely response to the formal inquiry letter.

.03 Improving Inquiry Techniques

If inquiries to legal counsel are not sufficiently detailed or specific, deficiencies in attorneys' responses may result. A conference between the auditor and the attorney may be necessary to clarify the attorney's written response and SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments,* paragraph 10 [AU section 337.10] provides for such a conference. However, to improve the auditor's ability to receive all of the information necessary to complete his audit, he may wish to consider including the following matters in an inquiry to legal counsel:

a. A request that the attorney specify the effective date of his response if it is other than the date of his reply.

b. A request that the attorney mail his response so that it will be received by a certain date.

c. A request that the nature of any litigation specifically identify (i) the proceedings, (ii) the claim(s) asserted, (iii) the amount of monetary damages sought, or if no amounts are indicated in preliminary case filings, a statement to that effect, and (iv) the objectives sought by the plaintiff, if any, other than monetary or other damages, such as performance or discontinued performance of certain actions.

d. A request that the attorney avoid such vague phrases as "meritorious defenses," "without substantial merit," and "reasonable chance" in expressing an opinion on the outcome of litigation.

e. If an opinion cannot be expressed on the outcome of litigation, a request that the attorney so state together with his reasons for that position.

f. A request that the attorney specify to what extent potential damages are covered by insurance. (It may be possible to obtain the opinion of the insurer's counsel regarding the applicability of insurance coverage.)

g. A request that the attorney provide a summary of material litigation, claims, and assessments settled during the period.

h. A statement that confirmation of the understanding regarding disclosure of unasserted claims and assessments is an integral part of the audit inquiry and that failure to so confirm will require a follow-up contact.

i. A statement that the attorney's response will not be quoted or referred to in the financial statements without first consulting with him.

[The next page is 7401.]

AAM Section 7400
Representation Letters

.01 Illustrative Representation Letter—Audit of Financial Statements

Introductory Comment (Extracted from the Appendix to SAS No. 19, *Client Representations* [AU section 333A])

The following letter is presented for illustrative purposes only. The written representations to be obtained should be based on the circumstances of the audit and the nature and basis of presentation of the financial statements being audited. The introductory paragraph should specify the financial statements and periods covered by the auditor's report, for example, "balance sheets of XYZ Company as of December 31, 19X1 and 19X0, and the related statements of income and retained earnings and cash flows for the years then ended." Similarly, representations concerning inventories and sales and purchase commitments would not be obtained if such items are not material to the company's financial position and results of operations or if they are not recorded in the financial statements under a comprehensive basis of accounting other than generally accepted accounting principles, for example, financial statements prepared on the cash basis of accounting.

The illustrative letter assumes that there are no matters requiring specific disclosure to the auditor. If such matters exist, they should be indicated by listing them following the representation, by reference to accounting records or financial statements, or by other similar means. For example, if an event subsequent to the date of the balance sheet has been disclosed in the financial statements, item 14 could be modified as follows: "Except as discussed in Note X to the financial statements, no events have occurred. . . ." Similarly, in appropriate circumstances, item 4 could be modified as follows: "We have no plans or intentions that may materially affect the carrying value or classification of assets and liabilities, except that certain marketable securities have been excluded from current assets based on our intention not to dispose of them, which is supported by the minutes of the December 7, 19X1, meeting of the board of directors."

Certain terms are used in the illustrative letter that are defined elsewhere in authoritative literature, for example, irregularities (SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities* [AU section 316]) and related parties (SFAS 57, *Related Party Disclosures,* paragraph 24f [AC R36.406]). To avoid misunderstanding concerning the meaning of such terms, the auditor may wish to furnish those definitions to the client and request that the client include the definitions in the written representations.

The illustrative letter assumes that management and the auditor have reached an understanding on the limits of materiality for purposes of the written representations. However, it should be noted that a materiality limit would not apply for certain representations, as explained in SAS No. 19, paragraph 5 [AU section 333.05].

Illustrative Representation Letter (Extracted from the Appendix to SAS No. 19 [AU section 333A])

(Prepared on client's letterhead)

(Date of Auditor's Report)

(To Independent Auditor)

In connection with your audit of the (identification of financial statements) of (name of client) as of (date) and for the (period of audit) for the purpose of expressing an opinion as to whether the (consolidated) financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of (name of client) in conformity with generally accepted accounting principles (other comprehensive basis of accounting), we confirm, to the best of our knowledge and belief, the following representations made to you during your audit.

1. We are responsible for the fair presentation in the (consolidated) financial statements of financial position, results of operations, and cash flows in conformity with generally accepted accounting principles (other comprehensive basis of accounting).

2. We have made available to you all—

   a. Financial records and related data.

   b. Minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.

3. There have been no—

   a. Irregularities involving management or employees who have significant roles in the internal control structure.

   b. Irregularities involving other employees that could have a material effect on the financial statements.

   c. Communications from regulatory agencies concerning noncompliance with, or deficiencies in, financial reporting practices that could have a material effect on the financial statements.

4. We have no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.

5. The following have been properly recorded or disclosed in the financial statements:

   a. Related party transactions and related amounts receivable or payable, including sales, purchases, loans, transfers, leasing arrangements, and guarantees.

   b. Capital stock repurchase options or agreements or capital stock reserved for options, warrants, conversions, or other requirements.

   c. Arrangements with financial institutions involving compensating balances or other arrangements involving restrictions on cash balances and line-of-credit or similar arrangements.

   d. Agreements to repurchase assets previously sold.

6. There are no—

   a. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.

   b. Other material liabilities or gain or loss contingencies that are required to be accrued or disclosed by Statement of Financial Accounting Standards No. 5 [AC section C59].

7. There are no unasserted claims or assessments that our lawyer has advised us are probable of assertion and must be disclosed in accordance with Statement of Financial Accounting Standards No. 5 [AC section C59].

8. There are no material transactions that have not been properly recorded in the accounting records underlying the financial statements.

9. Provision, when material, has been made to reduce excess or obsolete inventories to their estimated net realizable value.

10. The company has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged.

11. Provision has been made for any material loss to be sustained in the fulfillment of, or from inability to fulfill, any sales commitments.

12. Provision has been made for any material loss to be sustained as a result of purchase commitments for inventory quantities in excess of normal requirements or at prices in excess of the prevailing market prices.

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

14. No events have occurred subsequent to the balance sheet date that would require adjustment to, or disclosure in, the financial statements.

....
(Name of Chief Executive
Officer and Title)

....
(Name of Chief Financial
Officer and Title)

NOTES TO USER:

This illustration is only one example of a representation letter. Alternate wording is permissible and it may be advisable to tailor the letter to the needs of an engagement.

.02 Illustrative Representation Letter—Review of Financial Statements

(Prepared on client's letterhead)

(Date of Accountant's Report)

(To the Accountant)

In connection with your review of the (identification of financial statements) of (name of client) as of (date) and for the (period of review) for the purpose of expressing limited assurance that there are no material modifications that should be made to the statements in order for them to be in conformity with generally accepted accounting principles, we confirm, to the best of our knowledge and belief, the following representations made to you during your review.

1. The financial statements referred to above present the financial position, results of operations, and cash flows of (name of client) in conformity with generally accepted accounting principles. In that connection, we specifically confirm that—

   a. The company's accounting principles, and the practices and methods followed in applying them, are as disclosed in the financial statements.

   b. There have been no changes during the (period reviewed) in the company's accounting principles and practices.

   c. We have no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.

   d. There are no material transactions that have not been properly reflected in the financial statements.

   e. There are no material losses (such as from obsolete inventory or purchase or sales commitments) that have not been properly accrued or disclosed in the financial statements.

   f. There are no violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency, and there are no other material liabilities or gain or loss contingencies that are required to be accrued or disclosed.

   g. The company has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged.

   h. There are no related party transactions or related amounts receivable or payable that have not been properly disclosed in the financial statements.

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

   j. No events have occurred subsequent to the balance sheet date that would require adjustment to, or disclosure in, the financial statements.

2. We have advised you of all actions taken at meetings of stockholders, board of directors, and committees of the board of directors (or other similar bodies, as applicable) that may affect the financial statements.

3. We have responded fully to all inquiries made to us by you during your review.

....
(Name of Owner or Chief
Executive Officer and Title)

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

[Source: SSARS 1, Appendix D (AR section 100.55).]

.03 Illustrative Representation Letter—Personal Financial Statements

[*Date of accountant's report*]

[*To the accountant*]

In connection with your [*compilation, review, or audit*] of the statement of financial condition and the related statement of changes in net worth of James and Jane Person as of [*date*] and for the [*period*] then ended for the purpose of [*description*], we confirm, to the best of our knowledge and belief, the following representations made to you during your [*compilation, review, or audit*].

1. We are responsible for the fair presentation in the statements of financial condition and changes in net worth in conformity with generally accepted accounting principles. All assets are presented at their estimated current values and all liabilities are presented at their estimated current amounts, which have been determined in accordance with guidelines promulgated by the American Institute of Certified Public Accountants. (Because of our limited expertise with generally accepted accounting principles, including financial statement disclosure, we have engaged you to advise us in fulfilling that responsibility.)

2. We have made all financial records and related data available to you. We have not knowingly withheld from you any financial records or related data that in our judgment would be relevant to your [*compilation, review, or audit*].

3. The following have been properly recorded or disclosed in the financial statements:

    a. Related party transactions and related amounts receivable or payable, including sales, purchases, loans, transfers, leasing arrangements, and guarantees. I understand that related parties include members of my family as well as business entities in which I, or members of my family, have an investment that allows the exercise of control or significant influence.

    b. Arrangements with financial institutions involving compensating balances or other arrangements involving restrictions on cash balances and line-of-credit or similar arrangements.

    c. Agreements to repurchase assets previously sold.

4. There are no violations or possible violations of laws or regulations that have come to our attention whose effects are regarded as significant enough to be considered for disclosure in the financial statements or as a basis for recording a loss contingency, and there are no other material liabilities or gain or loss contingencies that are required to be accrued or disclosed.

5. There are no material transactions or balances that have not been properly recorded or disclosed in the financial statements.

6. We have satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor have any assets been pledged.

7. We have not retained an attorney for matters that may involve current or prospective litigation, and we are not aware of any pending or threatened litigation, claims, or assessments that should be disclosed in the financial statements.

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

9. No events have occurred subsequent to the date of the statement of financial condition that would require adjustment to, or disclosure in, the financial statements.

10. We have responded fully to all inquiries made to us by you during the engagement.

____
(James Person)

____
(Jane Person)

[Source: AICPA *Personal Financial Statements Guide.*]

.04 Illustrative Representation Letter to Other Accountants

(Firm's Letterhead)

[*Date*]

____
____
____

In connection with the report you have been requested to reissue on the financial statements of ________ [*client's name*] for the year ended ________ [*date*], which statements are to be included comparatively with similar statements for the year ended ________ [*date*], we make the following representations.

We have audited (or reviewed or compiled) the balance sheet of ________ [*client's name*] as of ________ [*balance-sheet date*] and the related statements of earnings, retained earnings, and cash flows for the year then ended. Our procedures in connection with the engagement did not disclose any events or transactions subsequent to ________ [*predecessor's balance-sheet date*] which, in our opinion, would have a material effect upon the financial statements, or which would require mention in the notes to the financial statements of ________ [*client's name*] for the year then ended.

Should anything come to our attention prior to the date our report is issued which, in our judgment, would have a material effect upon the financial statements covered by your report, we shall notify you promptly.

Very truly yours,

____

[*Engagement Partner's Signature*]

Note: If any matters come to the firm's attention that may require revision of the previous financial statements, they should be included in a separate paragraph after approval by the engagement partner.

.05 Letter to Other Accountants Upon Whose Work We Plan to Rely

(Firm's Letterhead)

[*Date*]

____

____

____

We are auditing the financial statements of ________________________________ [*client's name*], ________ [*parent company*]. The financial statements of ________________________________ [*other accountants' client's name*] that you are auditing are to be included in the financial statements of ______________________________ [*client's name*]. We will rely on your report on the financial statements in expressing an opinion on the (consolidated) financial statements of ________________________________ [*client's name*] (and subsidiaries). In that connection, we will refer to your report.

Please confirm to us that your firm is independent with respect to ______________________________ [*client's name*] and ________________________________ [*other accountants' client's name*] within the meaning of Rule 101 of the Code of Professional Conduct of the American Institute of Certified Public Accountants.

Please provide us promptly, in writing, with the following information in connection with your current examination of the financial statements of ________________________________ [*other accountants' client's name*] with respect to:

1. Related-party transactions or other matters that have come to your attention. We are aware of the following related parties: ________________________________ [*names of known related parties*].

2. Any limitation on the scope of your examination that is related to the financial statements of ________ [*client's name*], or that limits your ability to respond to this inquiry.

Please update your letter to indicate any additional matters of the type designated above that have come to your attention through the date of your report on the financial statements of ______________________________ [*other accountants' client's name*].

Very truly yours,

____

[*Engagement Partner's Signature*]

[The next page is 7501.]

AAM Section 7500
Communication With Audit Committees

.01 Illustrative Communication With Audit Committees

Addressee:*

Statement on Auditing Standards (SAS) No. 61, *Communication With Audit Committees* (AU section 380) issued by the AICPA Auditing Standards Board requires the auditor to communicate certain matters to those responsible for the oversight of the financial reporting process. The following comments regarding the scope and results of our audit of [*name of client*] for the year ended December 31, 19X2 will assist you in overseeing the financial reporting and disclosure process for which management is responsible.

Scope of Audit

Our responsibility is to express an opinion on the financial statements based on our audit. The audit is to be conducted in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statements presentation.

Results of Audit

[This part of the letter would address the following:

1. Management's choice of significant accounting policies and their application. This includes methods proposed for new transactions or events, significant unusual transactions, or controversial areas such as equity investments, off-balance sheet financing or revenue recognition;
2. Procedures used by management to determine accounting estimates and the data the auditor has considered to determine the reasonableness of the estimates;
3. Effects of audit adjustments that have or have not been recorded in the financial statements. Such adjustments, whether or not recorded, may have significant effects on current and future financial statements or on the company's control structure (i.e., a proposed adjustment may have resulted from errors detected during the audit that result from weaknesses in the internal control structure);
4. Other information presented by management that is included with the entity's audited financial statements. The auditor should discuss the nature of his responsibility for such information with the audit committee,* including procedures performed, if any, and the results;
5. Nature of and circumstances surrounding any disagreements with management about the application of GAAP, the determination of accounting estimates, or scope of the audit that could be significant to the entity's annual reporting;
6. Auditor's views about any accounting or auditing matters discussed by management with other auditors (opinion shopping);
7. Major discussions by management with the auditor about the initial or continued retention of the auditor; and

* Audit Committee, or other formally designated oversight group which is equivalent to the audit committee such as a finance committee or budget committee.

8. Any serious difficulties encountered in conducting the audit.]

This report is intended solely for the information and use of the audit committee,* management and others in the organization (or specified regulatory agency or other specified third party).

[*Signature*]

[*Date*]

[Source: SAS No. 61 (AU section 380)]

NOTES TO USER:

SAS No. 61 (AU section 380), is required to be followed for (1) entities that either have an audit committee or that have otherwise formally designated oversight of the financial reporting process to a group equivalent to an audit committee (such as a finance committee or budget committee) and (2) all Securities and Exchange Commission (SEC) engagements.

* Audit Committee, or other formally designated oversight group which is equivalent to the audit committee such as a finance committee or budget committee.

.02 Report on Reportable Conditions

[*Date of Auditor's Report on the Financial Statements*]

In planning and performing our audit of the financial statements of the ________________ [*client's name*] for the year ended ________________ [*financial statement date*], we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control structure. However, we noted the following matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the entity's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

Bank Reconciliations

Bank reconciliations have been prepared for the operating cash account, but they have not been in agreement with the general ledger, often by as much as ________________. At ________________, the general ledger balance varied from the bank reconciliation by $________.

In prior years, the bank reconciliations did not reconcile exactly to the general ledger; however, the variances were not as significant as in 199X. To maintain effective internal controls over cash, it is critical that bank accounts be reconciled to the general ledger monthly with differences identified and resolved immediately. At the present time, an adjusting journal entry should be made to bring the general ledger balance into agreement with the reconciled balance.

Accounts Payable

A listing of accounts payable as of ________________ could not be produced to support the general ledger amount. We were able to reconcile accounts payable to the general ledger amount by reviewing computer-generated accounts payable listings dated ________________, along with examining unpaid invoices at the time of our field work.

As indicated in previous letters to the Board, accounts payable has been an ongoing problem due to the fact that the accounts payable listing is not reconciled to the general ledger monthly. Proper recording of accounts payable is a key to maintaining adequate financial statements. Whether computer-generated or manually prepared, a detailed accounts payable listing should be reconciled monthly to the general ledger balance. All reconciliations should be reviewed and approved by someone other than the preparer, with the reviewer being responsible for ensuring that all differences are resolved.

Property and Equipment

Documentation provided to support the changes in property and equipment was not in agreement with the changes in the general ledger balances, for some categories, by as much as ________. Also, the computer-generated list of property and equipment was not in agreement with the total property and equipment recorded in the general ledger; therefore, this listing was not a useful resource.

The property and equipment computer listing should be reviewed, revised, and reconciled to the general ledger. Changes in property and equipment should be recorded timely and the detailed property and equipment listing should be reconciled to the general ledger balances monthly.

The procedures for recording fixed asset additions and deletions should be reviewed to determine their adequacy. Adjusting journal entries with regard to trade-ins, sales and other retirements of fixed assets should be reviewed by the Treasurer or someone other than the person preparing the entry. Examples of problems encountered include improper capitalization of assets when a like kind exchange or trade-in is involved and improper recording of gain or loss on sale of assets.

An annual or biannual physical inventory of equipment is an effective management tool to help maintain detail property and equipment records and strengthen controls of safeguarding equipment. The Board should consider making a physical inventory a standard procedure.

This report is intended solely for the information and use of the Board of Directors, management, and others within the entity.

Very truly yours,

____

[*Engagement Partner*]

.03 Report on Reportable Conditions That Also Identifies a Material Weakness

[Date of Auditor's Report on the Financial Statements]

In planning and performing our audit of the financial statements of the ________________ [*client's name*] for the year ended ________________ [*financial statement date*], we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control structure. However, we noted the following matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the entity's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

Accrued Vacation

Although accrued vacation has not been recorded on the financial statements, the amount of accrued vacation must be considered in determining the fair presentation of the financial statements. The year end analysis of accrued vacation had a balance significantly lower than the prior year's balance. The details of the analysis were traced to the "attendance control cards." We found (1) the number of days earned on the listing did not agree to that recorded in the cards, (2) individuals were reported in the cards with earned vacation but were not on the listing, and (3) some of the cards appeared to not have been maintained.

Detailed records of vacation days earned and used by employees should be timely and accurately maintained. At least annually, these days should be converted to dollar amounts. Management should review the conversion and consider reporting this liability on the financial statements for complete recognition of liabilities.

Discussions with the Office Manager revealed that not all employees are required to notify her when they use vacation days. All employees should be required to inform the Office Manager of all vacation days taken. Employees should also be asked to periodically review their vacation records with the Office Manager and to indicate their agreement by signing the records.

Bad Debts

During 199X, the Board approved the write-off of accounts receivable of about ________. The write-off was charged to revenue rather than to bad debt expense.

Procedures for recording bad debt write-offs should be reviewed for adequacy. All adjusting entries should be reviewed by the Treasurer or a member of management other than the person preparing the journal entry.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe that the following reportable condition is a material weakness.

Blank Checks

Blank checks are maintained in an unlocked cabinet along with the check signing machine.

Blank checks and the check signing machine should be locked in separate locations so as to prevent the embezzlement of funds.

This report is intended solely for the information and use of the Board of Directors, management, and others within the entity.

Very truly yours,

____

[*Engagement Partner*]

[The next page is 7601.]

AAM Section 7600
Reliance Letter

.01 Illustrative Reliance Letter

Addressee:

The following is in response to your letter to our firm dated ____.

We performed an audit of ABC Company's balance sheet dated December 31, 19X0, and the related statements of income, retained earnings, and cash flow for the year then ended. The financial statements were audited as of the financial statement date and the audit procedures performed were completed on March 28, 19X1 (audit report date). No additional audit procedures were performed subsequent to March 28, 19X1.

The audit was conducted in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. However, a properly designed and executed audit may not detect a material irregularity. For example, generally accepted auditing standards do not require that an auditor authenticate documents, nor is an auditor trained to do so. Also audit procedures that are effective for detecting a misstatement that is unintentional may not be effective for a misstatement that is intentional and is concealed through collusion between client personnel and third parties or among management or employees of the client.

We understand that you intend to rely on the report and associated statements in connection with *(describe as precisely as possible the transaction in connection with which the third party intends to rely on the report and statements).* It should be noted that the audit procedures performed in order to render an opinion on the financial statements of ABC Company may not be adequate or appropriate for this purpose. Because of the limitations inherent in the audit process we may not have detected all material misstatements. Accordingly, our audit was not intended for your benefit and should not be taken to supplant the inquiries and procedures that you should take to satisfy yourself as to ABC Company's credit-worthiness. We recommend that you perform your own due diligence investigation which should include but not be limited to the following steps (itemize). We emphasize that this list of procedures may not be all inclusive and that we cannot provide any assurance that the procedures we have mentioned will be sufficient for your purposes.

[*Signature*]

[*Date*]

[The next page is 7701.]

AAM Section 7700
Proposal Letter

.01 Illustrative Proposal Letter

[*Date*]

____
____
____

We appreciate this opportunity to present a proposal for [*nature of services*] and a brief description of our firm and services.

Our firm was formed in 19__. We have __ partners and __ staff and support personnel working with clients in accounting and auditing, taxation, and various consulting services. Although we serve all size clients, our clientele consists primarily of small and medium-size businesses such as yours.

Our professional objectives are to provide the highest quality services on a timely basis. As a member of the AICPA Division for Firm's Private Companies Practice Section, our accounting and auditing practice has been subjected to a review by another firm of CPAs. We received an unqualified opinion as a result of that review. We extend our client relationships to include ongoing contact and services to achieve our services objectives.

We have extensive experience in the ____ industry. This experience and related understanding of your industry's operations permit us to design, perform, and complete engagements for your company effectively and at a reasonable cost.

Our services include the following:

- Accounting, Auditing, and Attestation Services

  Our accounting, auditing, and attestation services include annual or special audits, compilations and reviews of financial statements, and the examination and review of financial and other information under the attestation standards. We accompany our report on audited financial statements with a reportable conditions letter and a management letter that include suggestions to correct internal control weaknesses and recommendations for operational efficiencies. Our purpose in making these suggestions is to help you accomplish your operational objectives. These suggestions often result in cost savings.

- Tax Services

  We offer diversified tax services, including assistance in all phases of federal, state, and local income taxes; estate, inheritance, and gift taxes; and payroll and other taxes. These services include tax return preparation, tax research, and representation of clients at administrative proceedings before the various taxing authorities. The objectives of our tax services are to minimize taxes and potential problems.

- Consulting Services

  Our consulting services are designed to assist clients in improving efficiency and profitability. Our approach offers assistance in such areas as developing plans for problem identification or implementing more effective operating controls, evaluating information systems and installing or upgrading data processing systems.

____________________, an audit partner, will be primarily responsible for your engagement.

As you requested, our proposal is for ________________ [*state nature of services*].

We estimate that our fees for the proposed services will be approximately $________, plus out-of-pocket expenses, billable as the work progresses. Our fees are based on time spent on the engagement. Should we encounter any unforeseen circumstances requiring additional time, you will be notified promptly of the situation.

Our fee estimate is based on the assumption that your personnel will prepare certain schedules and analyses for us. We also anticipate their assistance in locating invoices and other documents for our examination.

Our firm is organized and staffed to help you satisfy our business needs. Please call ________ with questions about this proposal.

Very truly yours,

____

[*Firm Signature*]

____

[The next page is 8001.]

AAM Section 8000

AUDIT RISK ALERT

> The material included in this section is intended to provide auditors with an overview of recent economic, professional, and regulatory developments that may affect audits they perform. The material in this section has not been approved, disapproved, or otherwise acted upon by a senior technical committee of the AICPA.

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AAM Section 8010

Audit Risk Alert—1993

Introduction

.01 This alert is intended to help auditors in planning their 1993 year-end audits. Successful audits are a result of a number of factors, including acceptance of clients with integrity; adequate partner involvement in planning, supervising, and performing audits; an appropriate level of professional skepticism; and the allocation of sufficient audit resources to high-risk areas. Addressing these factors in each audit engagement requires substantial professional judgment based, in part, on a knowledge of professional standards and current developments in business and government.

.02 Throughout the audit process, from the initial consideration of whether to accept a client to the issuance of an audit report, auditors should consider overall engagement risk. Engagement risk consists of three components:

- *The entity's business risk*—The risk associated with the entity's survival and profitability
- *The auditor's audit risk*—The risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated
- *The auditor's business risk*—The risk of potential litigation costs from an alleged audit failure and the risk of other costs (whether an audit failure is alleged or not) such as fee realization and reputational effects from association with the client

Although this alert does not provide a complete list of risk factors to be considered, and the items discussed do not affect risk in every audit, it can be used as a planning tool for considering matters that may be especially significant for your audits.

Implications of the Current Economic Environment

.03 Recovery from the recession has proven to be modest and slow. The first half of 1993 revealed weak economic growth but some analysts expect a pickup in the remainder of the year. However, the recession and the slow recovery have affected all entities. Although each particular entity may be affected differently depending upon the industry and geographic location in which it operates, auditors should be alert to certain implications of the current economic climate that may mean added audit risks.

.04 Entities may currently be questioning their continued existence or, in an attempt to strengthen their financial position, may be reorganizing or restructuring their business operations. This restructuring by some employers may include major layoffs of employees, which result in complex accounting events involving termination benefits and curtailment of pension plans. The decline in interest rates will affect those benefit obligations that are measured on a discounted basis. Impairment of assets, particularly goodwill, may be an accounting issue for entities that are experiencing economic difficulties. In addition, entities that have owned or leased real estate may be affected by the weak real estate market.

Going-Concern Problems

.05 In every audit, the auditor is required to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time. Statement on Auditing Standards (SAS) No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU section 341), notes that the auditor is not required to perform procedures specifically designed to detect going-concern problems. Information obtained from audit procedures planned and performed to achieve other audit objectives is sufficient to identify conditions or events that would cause the auditor to suspect there may be substantial doubt about the entity's ability to continue as a going concern. This stipulation is applicable to the auditor's responsibility for *initial* evaluation of going-concern status; however, when initial evaluation raises substantial doubt about the entity's ability to continue as a going concern, the auditor will need to apply additional procedures.

.06 In such circumstances, the auditor should ask management about its plans for dealing with the effects of the conditions or events underlying the going-concern question. The auditor should consider whether it is likely that the adverse effects will be mitigated by management's plans and whether those plans can be effectively implemented. Obtaining management's representations about its plans will not provide sufficient audit evidence to allay doubt about going-concern status. SAS No. 59 (AU section 341) states that the auditor should identify the elements that are particularly significant to overcoming the conditions or events associated with the going-concern question, and should plan and perform auditing procedures to obtain evidential matter about them. For example, if management states that it plans to obtain additional financing or to dispose of assets, the auditor should request and evaluate management's support for these plans.

.07 In some situations, the auditor may need to obtain prospective financial information from management. After reading the prospective financial information and the assumptions underlying the information, the auditor should consider the adequacy of support for the significant assumptions. The auditor's consideration of management's plans should include comparing prospective financial information generated in prior periods with actual results, and comparing prospective information for the current period with results achieved to date.

.08 If the auditor's doubts are alleviated by management's plans, the auditor should consider the need for financial statement disclosure of the principal conditions and events that initially caused the auditor to believe there was substantial doubt, and any mitigating factors, including management's plans.

.09 In some cases, an entity's condition may change and a situation previously giving rise to substantial doubt about an entity's ability to continue as a going concern may be favorably resolved (for example, when debt or equity is subsequently issued). The entity may ask the auditor to remove the going-concern explanatory paragraph from the previously issued report. If the auditor reissues the report, the Securities and Exchange Commission (SEC) has requested, although not required by authoritative auditing literature, that such reports contain an emphasis-of-a-matter paragraph informing users that the original auditor's report contained a going-concern explanatory paragraph. In addition, the emphasis-of-a-matter paragraph should provide disclosure of the principal conditions and events that resulted in the resolution of the going-concern matter.

Expected Dispositions of Business Operations

.10 Many U.S. entities have recently reorganized or restructured their business operations and made decisions to dispose immediately, or in the foreseeable future, of certain noncore businesses. Accounting for the disposal of a business segment or portion of a business segment is addressed in Accounting Principles Board (APB) Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions* (AC I13), its Interpretation, and in the Financial Accounting Standards Board's (FASB's) Emerging Issues Task Force (EITF) Issue No. 85-36, *Discontinued Operations with Expected Gain and Interim Operating Losses.* When management is contemplating the disposition of all or part of a business segment, a determination must be made as to whether a measurement date has been reached for purposes of applying the measurement principles of APB Opinion No. 30 (AC I13). If the disposition is not expected to occur within a year or the method of disposition is not yet known, it is likely that a measurement date, as defined in paragraph 14 of APB Opinion No. 30 (AC I13.402-.403), has not yet occurred. In such circumstances, applying the measurement and reporting principles of APB Opinion No. 30 (AC I13) would not be appropriate. However, SEC registrants contemplating the disposition of all or a portion of a business segment should discuss such dispositions in Management's Discussion and Analysis (MD&A) if they are reasonably likely to have a material effect on future operations, cash flow, or financial condition.

Asset Impairment

.11 Asset impairment continues to be a contentious auditing and financial reporting issue in the current economic climate. The FASB is expecting to issue, in the fourth quarter of 1993, an exposure draft of a Statement of Financial Accounting Standards titled *Accounting for the Impairment of Long-Lived Assets and Identifiable Intangibles.*

.12 The addition of an explanatory paragraph to the auditor's report because of an uncertainty concerning the recoverability of an asset is not a substitute for recognition of a loss when such recognition is appropriate (FASB Statement No. 5, *Accounting for Contingencies* (AC C59), and EITF Issue No. 84-28, *Impairment of Long-Lived Assets*). Accordingly, it should first be determined whether a loss should be recognized or disclosed in those situations involving uncertainties about the recoverability of an asset. If it is determined that a loss is not recognized or disclosed when it should be and the effect on the financial statements is material, the auditor's report should be modified for a departure from generally accepted accounting principles (GAAP).

Impairment of Goodwill

.13 For entities that have material amounts of goodwill recorded in the financial statements and the acquired entities are experiencing economic difficulties, the potential impairment of goodwill is a significant risk factor. In current practice, there is significant diversity regarding the recognition and measurement of the impairment of goodwill. APB Opinion No. 17, *Intangible Assets* (AC I60), states that the "estimation of value and future benefits of an intangible asset may indicate that the unamortized cost should be reduced significantly." This Statement has been interpreted in practice to support the measurement of any impairment on either a fair value or a recoverability approach. When an impairment of goodwill is recognized, the financial statements should disclose the underlying reasons for the writedown in accordance with APB Opinion No. 17 (AC I60).

Impact of Corporate Downsizing

.14 The past and current economic environment has led many entities to announce major layoffs of hourly and salaried employees in record numbers. Auditors should be aware of how these layoffs may result in certain complex accounting events, particularly when several events occur simultaneously. Examples of such events resulting from layoffs include the following.

.15 *Special Termination Benefits.* Some employers offer incentives, typically richer pension benefits, to employees to take early retirement. Costs related to these benefits generally should be charged to expense when the employees accept the offer and the amount can be reasonably estimated.

.16 *Contractual Termination Benefits.* Supplemental unemployment benefits or severance pay may be due contractually to certain employees, particularly union employees, upon layoff or termination. These costs generally should be charged to expense when it is probable that the employees will be entitled to the benefits and the amount can be reasonably estimated.

.17 *Curtailment of Defined Benefit Pension and Postretirement Plans.* A curtailment of one or more of these plans may result from a termination of employees if a substantial portion of expected future service of present employees is eliminated. A curtailment gain generally should be recorded when the related employees terminate or the plan suspension or amendment is adopted. A curtailment loss should be recognized when it is probable that a curtailment will occur and the loss is reasonably estimable.

.18 *Postemployment Benefits.* Postemployment benefits may be due to former or inactive employees. Such benefits may include salary continuation, supplemental unemployment benefits, and job training and counseling. Costs related to those benefits should be accrued during the employees' service period if (1) the employer's obligation relating to employees' rights to receive those benefits is attributable to employees' services already rendered, (2) the obligation relates to rights that vest or accumulate, (3) payment of the benefits is probable, and

(4) the amount can be reasonably estimated. Postemployment benefits that do not meet those conditions should be accrued when the layoff or termination is probable and the amount can be reasonably estimated. In addition, by law, terminated employees and their dependents have the right to continue coverage under certain employee benefit plans for eighteen or thirty-six months. The premiums that the employer is permitted to charge may not cover the full cost of the benefits. Any indicated loss should be recorded when the layoffs/terminations are probable and the amount of benefits can reasonably be determined.

.19 The primary accounting guidance for events related to employee termination is FASB Statement No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits* (AC P16), FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions* (AC P40), and FASB Statement No. 112, *Employers' Accounting for Postemployment Benefits* (AC P32). Auditors should determine whether the entity has identified and measured all the effects of layoffs and terminations. In certain cases, an actuary may be used to estimate the effects and auditors should refer to the guidance in SAS No. 11, *Using the Work of a Specialist* (AU section 336). Layoffs and terminations are not routine; therefore, the entity's controls over annual employee census information may not be applicable or effective.

Discount Rate Used to Measure Benefit Obligations

.20 Interest rates have declined steadily over the past several years and are currently at their lowest levels in more than a decade. Since assumed discount rates used in measuring benefit obligations should change to reflect changes in the general level of interest rates, auditors should consider the impact of the decline in the general level of interest rates on benefit obligations that are measured on a discounted basis. Assumed discount rates are used in measuring the projected, accumulated, and vested benefit obligations under FASB Statement No. 87, *Employers' Accounting for Pensions* (AC P16), and FASB Statement No. 106 (AC P40). The assumed discount rates should reflect the current rates at which the obligations could be *effectively settled*. Paragraphs 186-193 of Statement No. 106 (AC P16.138 fn 9a and 9b) provide guidance for selecting discount rates for purposes of measuring pension and postretirement benefit obligations. Auditors should carefully review management's selection of discount rates to determine that the discount rate conforms to such guidance. A reduction in the assumed discount rate can increase substantially the amount of the benefit obligation and may impact future service cost.

Contingent Losses Relating to Changes in OPEB Plans

.21 Faced with the reduction or elimination of postretirement benefits other than pensions (OPEB), retirees have been challenging in court their former employers' assertions that these entities have the unilateral right to eliminate or reduce such benefits. The absence of a written plan or conflicting written or oral communications of the plan have led to mixed outcomes in court and the ultimate outcome of such litigation may be uncertain. Auditors should determine whether entities have accounted properly for and disclosed material contingencies that may arise from the elimination or reduction in OPEB provided to retirees. Guidance on when it is appropriate to recognize a liability for a contingent loss and related disclosures is provided by FASB Statement No. 5 (AC C59).

Entities With Significant Real Estate Holdings

.22 Some entities that are not classified as real estate firms may have significant owned or leased real estate or provide financing under real estate collateralized obligations. Due to the weak real estate market, certain current values are significantly lower than they were even as recently as six months to a year ago. One of the factors contributing to the rapid decline in values is the emergence of substantial real estate portfolios available for sale. Entities that have provided real estate financing may not have considered the full impact of these value declines. Even recent independent appraisals may have failed to fully reflect current market conditions as the appraisal may be based in part on specific assumptions stipulated by the entity ordering the appraisal. Real estate, although traditionally considered a long-term investment, is currently even less liquid than in prior years, due to excess supply and limited credit availability.

.23 Auditors encountering the risks described above should consider the need for appropriate write-downs or reserves and the impact on any disclosures required by FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* (AC F25), or voluntary fair value disclosures. An auditing interpretation was issued in February 1993 to provide auditors performance and reporting guidance related to fair value disclosures. Refer to Interpretation No. 1, "Performance and Reporting Guidance Related to Fair Value Disclosures", of SAS No. 57, *Auditing Accounting Estimates* (AU section 9342.01-.10).

Regulatory Developments

Environmental Matters

.24 Investors, creditors, and regulators continue to focus on environmental matters. Over the past several years, the SEC staff has been closely monitoring the adequacy of environmental disclosures in connection with its review of filings. In an effort to determine whether appropriate disclosure is made, the SEC staff receives from the Environmental Protection Agency (EPA) lists of all entities that have been designated as potentially responsible parties (PRPs) on hazardous waste sites as well as information concerning entities subject to the cleanup requirements under the Resource Conservation and Recovery Act.

.25 The AICPA frequently receives inquiries about how to account for environmental contingencies and liabilities and the related audit consequences. The applicable accounting literature includes FASB Statement No. 5 (AC C59) and FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss* (AC C59). In addition, guidance is included in EITF Issue No. 89-13, *Accounting for the Cost of Asbestos Removal*, Issue No. 90-8, *Capitalization of Costs to Treat Environmental Contamination*, and Issue No. 93-5, *Accounting for Environmental Liabilities.* The EITF reached a consensus in Issue No. 93-5 that an environmental liability should be evaluated independently from any potential claim for recovery (a two-event approach) and that the loss arising from the recognition of an environmental liability should be reduced only when a claim for recovery is probable of realization.

.26 In June 1993, SEC Staff Accounting Bulletin (SAB) No. 92, *Accounting and Disclosures Relating to Loss Contingencies*, was issued. Among other things, SAB No. 92 indicates that it is *not ordinarily* appropriate to offset in the balance sheet a claim for recovery that is probable of realization against a probable contingent liability. The staff believes that ". . . separate presentation of the gross liability and related claim for recovery in the balance sheet most fairly presents the potential consequences of the contingent claim on the company's resources and is the preferable method of display."

.27 SAB No. 92 also indicates that if an entity is jointly and severally liable with respect to a contaminated site but there is a reasonable basis for apportionment of costs among responsible parties, the entity need not recognize a liability for costs apportioned to other responsible parties. However, if it is probable that other responsible parties will not fully pay costs apportioned to them, the entity should include its best estimate, before consideration of potential recoveries from other parties, of the additional costs it expects to pay. A note to the financial statements should describe any additional loss that is reasonably possible. In addition, SAB No. 92 requires expanded disclosures of environmental and other contingencies.

.28 In applying the accounting literature, auditors should be alert to the possibility of an inappropriate delay in the accrual of an environmental loss until sufficient information is available to determine the *best* estimate of the liability. Interpretation No. 14 (AC C59) requires entities to accrue a loss contingency when the estimated loss is within a range of amounts.

.29 The applicable auditing guidance for environmental matters is found in SAS No. 11 (AU section 336); SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AU section 337); SAS No. 54, *Illegal Acts by Clients* (AU section 317); and SAS No. 57 (AU section 342). Auditors should consider asking management whether the entity or any of its subsidiaries has been designated as a PRP by the EPA or otherwise has a high-risk exposure to environmental liabilities. When more than one PRP is associated with a contaminated site, each party may be contingently liable for the full amount of cleanup costs and fines because of the joint and several nature of environmental laws. Such exposure could result in the need for an entity to accrue for cleanup costs or disclose a contingency and, possibly, necessitate the addition of an explanatory paragraph in the auditor's report.

.30 Possible indicators of an increased risk of an entity's exposure to environmental liabilities 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 liability to third parties.

Providing Access to or Photocopies of Workpapers to Regulators

.31 SAS No. 41, *Working Papers* (AU section 339), provides auditors guidance on the functions, nature, content, ownership and custody of working papers and observes that working papers are the property of the auditor. The auditor's working papers should not be regarded as part of, or a substitute for, the client's accounting records. In some situations, auditors may be *obligated* by law, regulation, or audit contract to provide access to or photocopies of their workpapers to a regulator.

.32 The AICPA has developed guidelines to assist auditors in fulfilling these obligations while also maintaining control over the workpapers. (For a complete copy of these guidelines, refer to the Notice to Practitioners "Guidance for Independent Auditors When Required to Provide Access to or Photocopies of Workpapers to Regulators" in the July/August 1993 issue of the *CPA Letter*.) Auditors should be aware that the guidelines do not apply to situations involving a request from the Internal Revenue Service (IRS) or firm practice-monitoring programs to comply with AICPA or state professional requirements, such as peer or quality reviews, or in response to a subpoena.

.33 *Providing Access to Workpapers.* When required by law, regulation, or audit contract to provide a regulator access to workpapers, the auditor should—

- Ensure that the client and the audit team are aware that the workpapers may be reviewed by the regulator, and have the client acknowledge in the engagement letter that the workpapers are the property of the auditor but the regulator may be provided with access to workpapers, upon request in accordance with the law, regulation, or audit contract.
- Ensure that a request for access to workpapers by the regulator is in writing. The auditor should communicate specific details (for example, date, time, and location) to the client of how access to the workpapers will be provided, and request the client acknowledge to the auditor in writing that the auditor is *required* to provide such access to the regulator. In the event the client does not comply with this request, the auditor may wish to consult his or her own legal counsel.
- Maintain control over the workpapers at all times. Unless expressly provided for by law, regulation, or audit contract, only workpapers related to specific requests should be made available.

.34 *Providing Photocopies of Workpapers.* In addition to the above guidelines, when required by law, regulation, or audit contract to provide a regulator photocopies of workpapers, the auditor should—

- Provide copies of only those specific portions of workpapers that were requested, preferably only requests made during the course of an on-site review.
- Consider asking the client to review requested workpaper copies before they are submitted to the regulator.
- Ensure that control over copies of the workpapers is maintained by clearly labeling all workpaper copies *confidential* and indicating that secondary distribution of the workpapers is not permitted without the written approval of the auditor. Copies should be transmitted to the regulator with a cover letter requesting confidential treatment of information contained in the workpapers.

New Auditing Pronouncements

Comfort Letters

.35 In February 1993, the AICPA's Auditing Standards Board (ASB) issued SAS No. 72, *Letters for Underwriters and Certain Other Requesting Parties* (AU section 634). Historically, accountants have provided comfort letters to underwriters in connection with securities offerings registered pursuant to the Securities Act of 1933. SAS No. 72 (AU section 634) expands the availability of comfort letters beyond those underwriters to include (1) broker/dealers or other financial intermediaries in connection with the offering or placement of securities, and (2) buyers and sellers in connection with an acquisition when an exchange of stock is involved. These parties are required to provide the accountant with a letter making certain representations, as described in paragraphs 6 and 7 of the Statement (AU section 634.06 and .07). If the party requesting the comfort letter is unable to provide those representations, the accountant may not provide them with a comfort letter but may provide them with other services, such as a review under SAS No. 71, *Interim Financial Information* (AU section 722), or agreed-upon procedures under SAS No. 35, *Special Reports—Applying Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement* (AU section 622).

.36 The Statement also requires the accountant to perform a SAS No. 71 (AU section 622) review to provide negative assurance in a comfort letter on interim financial information. SAS No. 72 (AU section 634) supersedes SAS No. 49, *Letters for Underwriters,* and became effective for all comfort letters issued on or after June 30, 1993.

Reports on Service Organizations

.37 Many entities use outside service organizations to perform tasks requiring expertise or technology that does not exist within the organization. Service organizations provide various levels of services ranging from performing a specific task under the direction of an entity to replacing entire business units or functions of the entity. Some examples of service organizations are bank trust departments that invest and hold assets for employee benefit plans and data processing centers that process transactions and related data for other organizations.

.38 When an entity (a user organization) uses a service organization, the functions or processing performed by the service organization may have a significant effect on the user organization's financial statements. Because the processing will be subjected to control policies and procedures that are physically and operationally separate from the user organization, the internal control structure of the user organization may include a component that is not directly under the control and monitoring of the user organization's management. SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AU section 319), requires an auditor to obtain a sufficient understanding of an entity's internal control structure to plan the audit. For this reason, planning the audit may require that a user auditor gain an understanding of the control policies and procedures performed by the service organization.

.39 When a user organization relies on a service organization's control policies and procedures over the processing of transactions that are material to a user organization's financial statements, those control policies and procedures should be considered by the user auditor. One method of obtaining information about those policies and procedures is to obtain a service auditor's report. SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AU section 324), which was issued in April 1992 and superseded SAS No. 44, *Special-Purpose Reports on Internal Accounting Control at Service Organizations*, provides guidance to auditors performing an audit of a user organization and to service auditors performing procedures and reporting on the control policies and procedures at a service organization.

.40 Auditors frequently inquire whether it is necessary to obtain a service auditor's report when their clients use a service organization. The fact that an entity uses a service organization does not, in and of itself, indicate that a user auditor must obtain a service auditor's report.

.41 Factors to consider in determining whether to obtain a service auditor's report are—

- The materiality of transactions or accounts affected by the service organization.
- The extent to which the user organization retains responsibility for authorizing the transactions and maintaining the related accountability. When the service organization has authority to initiate and execute transactions for user organizations, there is a greater probability that the user auditor will need to obtain a more detailed understanding of the policies and procedures at the service organization. For example, it is common for trust departments of banks to be given discretionary authority to buy and sell securities for user organizations (particularly employee benefit plans) based on guidelines in a trust agreement. In such circumstances, the user auditor would probably need to gain a more detailed understanding of the policies and procedures at the trust department to plan the audit.
- The availability of other information at the user organization that may provide the auditor with sufficient information to plan the audit; for example, user manuals, system overviews, and technical manuals.

Auditors issuing service auditors' reports dated after March 31, 1993, are required to follow the guidance in SAS No. 70 (AU section 324) and may have questions about its implementation. The Auditing Standards Division expects to issue an Auditing Procedure Study (APS), *Implementing SAS No. 70, Reports on the Processing of Transactions by Service Organizations*, in the first quarter of 1994.

GAAP Hierarchy

.42 In January 1992, the ASB issued SAS No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report* (AU section 411), which revised the GAAP hierarchy. The revised hierarchy elevates the authority of certain accounting pronouncements, including AICPA Audit and Accounting Guides and Statements of Position (SOPs), and FASB EITF consensus positions. Because several organizations establish GAAP, there is not one publication that includes all GAAP pronouncements; however, the following references contain pronouncements that are authoritative (*must know*) GAAP and—if acquired and maintained—should provide auditors with an appropriate accounting library.

.43 *FASB Original Pronouncements—Accounting Standards.* This two-volume set contains the original text of accounting pronouncements. It includes FASB Statements of Financial Accounting Standards and Interpretations, APB Opinions, AICPA Accounting Research Bulletins, and FASB Technical Bulletins. The pronouncements are arranged chronologically and the text includes a topical index. (Product No. 005043; $83.50.) In addition, for SEC registrants, rules and interpretive releases of the SEC are considered equivalent to *FASB Original Pronouncements—Accounting Standards.*

.44 *AICPA Audit and Accounting Guides.* These guides summarize the practices applicable to specific industries and describe relevant matters, conditions, and procedures unique to these industries. See the *AICPA Catalog of Publications* for a listing of available guides ($26 per guide).

.45 *AICPA Technical Practice Aids (Including SOPs).* SOPs issued by the AICPA Accounting Standards Division and Accounting Standards Executive Committee (AcSEC) Practice Bulletins are included in this text, which also contains a selection of nonauthoritative audit and accounting questions answered by the AICPA's Technical Information Service. SAS No. 69 (AU section 411) elevated the status of AcSEC Practice Bulletins to the authority of established accounting principles. (Product No. 005053; $60.)

.46 *FASB Emerging Issues Task Force Abstracts.* This text contains a summary of the proceedings of the FASB's EITF. Each abstract summarizes the accounting issues involved and the results of the discussion, including any consensus reached on the issue. SAS No. 69 (AU section 411) elevated the status of EITF consensuses to the authority of established accounting principles. (Available from the FASB, (203) 847-0700, extension 10, Product No. EAB93; $33.)

Reporting on Internal Control

.47 In May 1993, Statement on Standards for Attestation Engagements (SSAE) No. 2, *Reporting on an Entity's Internal Control Structure Over Financial Reporting* (AT section 400), was issued.[1] This Statement supersedes SAS No. 30, *Reporting on Internal Accounting Control,* and is effective for an examination of management's assertion on the effectiveness of an entity's internal control structure over financial reporting when the assertion is as of December 15, 1993, or thereafter. SSAE No. 2 (AT section 400) provides guidance to accountants who are engaged to examine and report on management's written assertion about the effectiveness of an entity's internal control structure over financial reporting. The Statement *does not change* the auditor's responsibility for considering the entity's internal control structure over financial reporting in an audit of financial statements.

.48 SSAE No. 2 (AT section 400) requires that, for a practitioner to be engaged to examine management's assertion, management should evaluate the effectiveness of the entity's financial reporting controls using reasonable criteria for effective internal control structures established by a recognized body. Accountants should be aware that the ASB recently expressed a preference for use of the criteria in the Committee of Sponsoring Organizations (COSO) of the Treadway Commission's Report, *Internal Control—Integrated Framework* (Product No. 990002; $50), as opposed to the criteria in SAS No. 55 (AU section 319). The ASB expects to replace the concepts in SAS No. 55 (AU section 319) with the concepts in the COSO Report throughout the auditing and attestation literature.

.49 Recently enacted federal requirements mandate that management report on the effectiveness of its internal control structure over financial reporting; for example, the Federal Deposit Insurance Corporation (FDIC) Improvement Act of 1991. These actions include various forms of auditor involvement—most often a requirement to attest to management's report. SSAE No. 2 (AT section 400) provides guidance for accountants who are engaged to attest to such reports.

Compliance Attestation

.50 An exposure draft of proposed SSAE, *Compliance Attestation,* was issued in April 1993. The proposed Statement provides guidance to assist accountants in accepting an agreed-upon procedures or examination engagement relating to an entity's compliance with specified laws or regulations; planning and performing the engagement; and reporting on the engagement. Importantly, the proposed guidance applies to auditors of insured depository institutions who perform agreed-upon procedures to test the entity's compliance with specified safety and soundness laws, as required by the FDIC Improvement Act of 1991.

.51 A final standard, which will be SSAE No. 3 (AT section 500), is expected to be issued by year-end and is effective for engagements in which management's assertion is as of or for a period ending June 15, 1994, or thereafter. However, for engagements to perform agreed-upon procedures to test a financial institution's compli-

[1] In April 1993, the following SSAEs were codified into SSAE No. 1, *Attestation Standards:*
- *Attestation Standards* (AT section 100)
- *Financial Forecasts and Projections* (AT section 200)
- *Reporting on Pro Forma Financial Information* (AT section 300)

ance with specified safety and soundness laws in accordance with the FDIC Improvement Act of 1991, this Statement is effective when management's assertion is as of December 31, 1993, or thereafter.

Using the Work of a Specialist

.52 An exposure draft of a proposed SAS, *Using the Work of a Specialist,* was issued in April 1993 to clarify existing guidance for auditors who use the work of a specialist in performing an audit of financial statements in accordance with generally accepted auditing standards (GAAS). When issued, the Statement will supersede SAS No. 11 (AU section 336).

.53 Among other changes, the document clarifies its applicability to situations in which—

- Management engages a specialist to prepare, or assist in the reparation of, amounts or disclosures in the financial statements, and the auditor intends to use that specialist's work as evidential matter.
- Management engages a specialist employed by the auditor's firm to provide advisory services and the auditor intends to use that specialist's work as evidential matter.
- The auditor engages a specialist and intends to use that specialist's work as evidential matter.

The proposed Statement also clarifies that when a specialist has a relationship with the client and the auditor believes the relationship may impair the specialist's objectivity, the auditor should perform additional procedures related to the specialist's methods, assumptions, or findings. A final Statement is expected by mid-1994.

Guidance on the Effect of Information Technology

.54 The Auditing Standards Division plans to issue an APS titled *Audit Considerations in Common Computer Environments,* that describes the possible effect on the financial statement audit of an entity's use of information technologies such as electronic data interchange (EDI), microcomputers, local area networks (LANs), end-user computing, database management systems, and telecommunications. (A notice will be published in the *CPA Letter* when the APS is issued.)

.55 EDI is the electronic exchange between entities of business data in a standard format, replacing documents such as purchase orders, invoices, and checks. A customer and vendor using EDI could complete an entire business transaction and the only physical paper exchanged would be the bill of lading that accompanies the goods shipped. EDI commonly is used in the retailing and auto manufacturing industries for purchases from suppliers but it is also used in the banking industry for electronic funds transfer and in the insurance industry to process medical benefit claims. Entities of all sizes already may be using EDI because some entities, such as retailers and auto manufacturers, often require the use of EDI by their suppliers as a condition of doing business.

.56 Because entities are increasingly reliant on computers for significant accounting applications, auditors are using computer-assisted audit techniques (CAATs) to perform more efficient and effective audits of those entities' financial statements. CAATs are tools and techniques that include the computer as an integral part of the audit process. Auditors may use the computer to access data in an entity's accounting system, analyze and test that data, test the controls over processing of the data, and transform that data into the financial statements. The computer may be used in many ways to facilitate a financial statement audit, such as assisting in the management of the audit.

.57 The Auditing Standards Division also plans to issue an APS titled *Auditing With Computers.* This APS describes the computer tools and techniques available for use in the audit process, how those tools work, some of their advantages and disadvantages, and the typical audit tasks those tools can accomplish. It also describes factors the auditor should consider when choosing the most appropriate computer tool for the particular audit task and when deciding whether it would be more appropriate to involve a specialist in developing or implementing

CAATs. This APS will withdraw the 1979 Audit and Accounting Guide, *Computer-Assisted Audit Techniques*. (A notice will be published in the *CPA Letter* when the APS is issued.)

Audit Communication and Reporting Issues

Communications Between Predecessor and Successor Auditors

.58 When a change of auditors has taken place or is in process, certain communications between predecessor and successor auditors are required by SAS No. 7, *Communications Between Predecessor and Successor Auditors* (AU section 315). The initiative in communicating is the responsibility of the successor auditor, who should attempt certain communications prior to acceptance of the engagement. Authoritative standards require such communications because they provide key evidence in the determination of the level of audit risk associated with a potential audit client. Prior to acceptance of a new engagement, an auditor should weigh carefully the high level of audit risk that may be associated with a new audit client when the predecessor auditor has had disagreements with management on matters of accounting principle or auditing procedures or has concerns regarding management's integrity or the reliability of management's representations.

Reporting on Other Information

.59 Questions frequently arise as to how auditors should report on information that is presented outside the basic financial statements. Auditors are reminded of the following Statements that address reporting on such information:

- SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AU section 550)
- SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AU section 551)
- SAS No. 52, *Omnibus Statement on Auditing Standards—1987*; "Required Supplementary Information" (AU section 552)

To determine which SAS applies to an engagement, auditors must answer the following questions: (1) Is the information included in an auditor-submitted or client-prepared document? (2) Does the FASB or the Governmental Accounting Standards Board (GASB) require that the information be presented?

.60 Ordinarily, if the document is auditor-submitted, the applicable auditing standard is SAS No. 29 (AU section 551). However, for client-prepared documents that include information required by the FASB or GASB, auditors should follow the guidance in SAS No. 52 (AU section 552). If the client-prepared information is not required by the FASB or GASB, the appropriate auditing standard is SAS No. 8 (AU section 550).

Reporting on the Application of GAAP

.61 Accountants are sometimes engaged by entities, for whom they are not the continuing auditor (that is, the entity's financial statements are audited, reviewed or compiled by another accountant), to provide consultations regarding a proposed or completed transaction. SAS No. 50, *Reports on the Application of Accounting Principles* (AU section 625), applies to accountants who provide reports, written or oral, on the accounting treatments of proposed or completed specific transactions to persons or entities other than continuing clients.

.62 Before providing advice, the accountant should consider the identity of the requestor of the report, the circumstances and purpose of the request, and the use of the resulting report. SAS No. 50 (AU section 625) also requires the reporting accountant to exercise due professional care, have adequate technical training and proficiency, properly plan and supervise the engagement, and accumulate sufficient information to provide a reasonable basis for the professional judgment described in the report.

.63 In forming a judgment, the accountant should—

- Understand the form and substance of the transaction.
- Review applicable accounting principles.
- Consult with other professionals or experts, as appropriate.
- Perform research and consider precedents and analogies, as appropriate.

Finally, and most important, the reporting accountant is required to consult with the entity's continuing auditor or accountant to ascertain all the relevant facts. The continuing auditor or accountant can often provide information not otherwise available to the reporting accountant, such as the form and substance of the transaction, how management has applied accounting principles to similar transactions, and whether the method of accounting recommended by the continuing auditor is disputed by management.

Reporting on Financial Statements for Use in Other Countries

.64 United States auditors may be engaged to report on the financial statements of a United States entity that have been prepared in conformity with accounting principles generally accepted in another country for use outside the United States (or for *limited* distribution in the United States). SAS No. 51, *Reporting on Financial Statements Prepared for Use in Other Countries* (AU section 534), provides auditors guidance for such engagements. Auditors should comply with United States GAAS in all cases; however, modification of certain procedures for assertions embodied in the non-United States GAAP financial statements may be necessary.

Reporting on Uncertainties

.65 Situations are continually noted in which explanatory paragraphs describing uncertainties are inappropriately used in the auditor's report. In fact, the SEC staff has indicated that this reporting continues to be a problem that they are monitoring closely.

.66 FASB Statement No. 5 (AC C59) requires an estimated loss from a loss contingency be charged to income (1) if it is probable that an asset has been impaired or a liability has been incurred at the date of the financial statements, and (2) the amount of the loss can reasonably be determined.

.67 SAS No. 58, *Reports on Audited Financial Statements* (AU section 508), requires auditors to consider adding an explanatory paragraph (after the opinion paragraph) to the standard report when a material uncertainty is *not susceptible to reasonable estimation by management.* (Examples of uncertainties include lawsuits against the entity and tax claims by tax authorities when precedents are not clear.)

.68 Auditors should carefully evaluate situations in which management asserts that it is unable to estimate certain financial statement elements, accounts, or items to determine whether these situations are not inappropriately treated as uncertainties. Management's assertion that it is not able to estimate should raise concerns about the possibility of financial statement misstatement or a scope limitation. If the auditor believes that the financial statements are materially misstated, a qualified or adverse opinion is required because of the GAAP departure. A scope limitation should result in a qualified opinion or a disclaimer of opinion. An explanatory paragraph describing an uncertainty may be included in the auditor's report *only after* the auditor has determined that the financial statements are prepared in accordance with GAAP.

Reissuance of Auditor's Reports

.69 Questions have been raised recently concerning reissuing auditor's reports (by means of providing a written consent or otherwise) when a new uncertainty (for example, going concern or litigation) has arisen subsequent to the date of the original report. SAS No. 58 (AU section 508) and SAS No. 1, *Codification of Auditing Standards and Procedures;* "Dating of the Independent Auditor's Report" (AU section 530), provide guidance for such situations.

.70 In general, a new uncertainty arising subsequent to original issuance, but before the reissuance of the report, should be evaluated in the same manner as an uncertainty arising prior to the original issuance. The evaluation of the new uncertainty should be essentially the same for both materiality and the need to modify the report.

.71 If, in connection with the reissuance of the auditor's report on the latest annual financial statements, the auditor encounters conditions that create substantial doubt about the entity's ability to continue as a going concern within twelve months from the date of the audited balance sheet, the reissued report should contain an explanatory paragraph following the opinion paragraph calling attention to the new uncertainty. On the other hand, if an event is anticipated to occur *after* twelve months from the date of the audited balance sheet and is likely to raise a going-concern question, the reissued auditor's report may include an emphasis-of-a-matter paragraph calling attention to the event.

.72 When the subsequent event is the type that requires disclosure only—without restatement of amounts and without need for a report modification—(for example, acquisition, issuance of securities, settlement of litigation, or loss arising from fire or flood), the subsequent event disclosure may be marked *unaudited.* In these situations, the reissued auditor's report, including the date, should not be modified.

.73 When a report modification is added, necessitating that the added disclosures be audited, the report should be dual-dated for the subsequent event note disclosure. In most cases, dual-dating (rather than updating) is sufficient and highlights the fact that the new uncertainty arose subsequent to the date of the original report.

Current-Value (Fair-Value) Reporting

.74 Current-value (fair-value) accounting is not considered to be an other comprehensive basis of accounting, therefore, the auditor should not report on such information in a stand-alone presentation. However, if there is a written agreement between the client and another party which specifies a stand-alone financial presentation of current-value (fair-value) information, an auditor may report on such information in accordance with SAS No. 62, *Special Reports* (AU section 623), as a special-purpose presentation in conformity with a contractual agreement. However, the report would include a restriction to limit distribution to the parties in the agreement.

Agreed-Upon Procedures Engagements

.75 Accountants are increasingly being engaged to perform agreed-upon procedures and should be aware that performance and reporting standards for agreed-upon procedures engagements are located at various places in the authoritative literature. Accountants are cautioned to avoid agreeing to perform procedures that are subjective and may be open to varying interpretations. Examples of procedures that may be performed in an agreed-upon procedures engagement include—

- Execution of a statistical sampling application (to arrive at a statistical conclusion), after agreeing on relevant parameters.
- Inspection of specified documents evidencing certain types of transactions or detailed attributes thereof.
- Reading of documents, schedules, or analyses for comparison with certain specified attributes.
- Performance of specific procedures on work performed by others.
- Performance of mathematical computations (for comparison with a predetermined amount).

.76 Examples of inappropriate procedures include—

- Mere reading of specified subject matter (this does not constitute a procedure sufficient to permit an accountant to report a finding on the results of applying agreed-upon procedures).
- Mere reading of the work performed by others solely to describe their findings.

- Evaluating the competency or objectivity of another party, and similar subjective procedures.
- Obtaining an understanding about a particular subject matter when no objective finding is possible.

.77 Accountants are reminded that the following standards provide guidance for agreed-upon procedures engagements:

- SAS No. 35, *Special Reports—Applying Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement* (AU section 622)
- SOP 90-6, *Directors' Examinations of Banks*
- SSAE No. 1, *Attestation Standards* (AT section 100)
- SSAE No. 1, *Financial Forecasts and Projections* (AT section 200)

Following is a brief overview of the standards that provide guidance for agreed-upon procedures engagements.

.78 *SAS No. 35* (AU section 622). Accountants may accept an agreed-upon procedures engagement and should follow the guidance in SAS No. 35 (AU section 622) when engaged to apply procedures to one or more specified elements, accounts, or items of a financial statement. According to SAS No. 35 (AU section 622), distribution of the report is to be restricted to the named parties involved in the engagement. The report should (1) include the specified elements, accounts, or items to which the agreed-upon procedures were applied, (2) enumerate the procedures that were performed, (3) state the accountant's findings, and (4) disclaim an opinion on the specified elements, accounts or items. In addition, the report should include a statement that the report relates *only* to the specified elements, accounts, or items.

.79 *SOP 90-6.* This Statement was issued to emphasize the limitations on the scope of an accountant's work when he or she is engaged to perform bank directors' examinations. The major reporting difference compared to the requirements in SAS No. 35 (AU section 622) is inclusion of a sentence that highlights the omission of procedures in high-risk areas.

.80 *SSAE No. 1,* Attestation Standards (AT section 100). The performance and reporting standards for an agreed-upon procedures engagement under SSAE No. 1 (AT section 100) are basically the same as those enumerated above for SAS No. 35 (AU section 622). Accountants should note that the following exceptions exist:

- The report requires reference to and presentation of an assertion.
- Conclusions on the results of applying the agreed-upon procedures may be in the form of a summary of findings, negative assurance, or both.
- An assertion(s) may be prepared in conformity with specified criteria that have been agreed upon by the asserter and the user(s) of the report.

.81 *SSAE No. 1,* Financial Forecasts and Projections (AT section 200). The performance and reporting standards for agreed-upon procedures under SSAE No. 1 (AT section 200) parallel SAS No. 35 (AU section 622) and SSAE No. 1 (AT section 100) with the following exceptions:

- The prospective financial statements must include a summary of significant assumptions.
- Prospective agreed-upon procedures engagements have explicit working paper requirements.
- In addition to the reporting requirements in SAS No. 35 (AU section 622), the accountant's report should include (1) a caveat that the prospective results may not be achieved, and (2) a statement indicating that the accountant assumes no responsibility to update the report for events and circumstances occurring after the date of the report.

A Reminder—SECPS Communication Requirements

.82 Member firms of the SEC Practice Section (SECPS) of the AICPA are reminded of the following communication requirements:

- Litigation should be reported to the Quality Control Inquiry Committee (QCIC) within thirty days of service of the lawsuit. The reporting requirement covers any litigation against the firm or its personnel or any proceeding or investigation publicly announced by a regulatory agency that alleges deficiencies in the conduct of an audit of the financial statements or reporting thereon of a present or former SEC client. Such reports should also include certain allegations resulting from nonaudit services.
- Within five days of becoming aware of the cessation of a client-auditor relationship (either by resignation, termination, or replacement by another auditor), the firm is required to formally notify the client in writing that the relationship has ended. The auditor should transmit simultaneously a copy of this SECPS client notification letter to the Chief Accountant of the SEC. The letter may be sent to the Office of the Chief Accountant by either mail (return receipt suggested) or FAX (202) 504-2724. Mailed letters (including originals confirming an earlier fax) should be addressed to: Office of the Chief Accountant, Attn: SECPS Letter File, Securities and Exchange Commission, 450 Fifth Street, NW, Mail Stop 9-5, Washington, DC 20549.

Audit Problems to Watch For

Auditor Skepticism

.83 Auditors should be skeptical about the answers they receive from management. Explanations received from an entity's management are merely the first step in an audit process, not the last. Listen to the explanation, then examine or test it by looking at sufficient competent evidential matter. The familiar phrase *healthy skepticism* should be viewed as a *show-me* attitude and not a predisposition to accepting unsubstantiated explanations. Auditors should document working paper notes and conclusions as if they will be challenged on them because a likelihood exists that this will occur.

Management Fraud

.84 This past year has seen a significant number of highly publicized cases of alleged or actual management fraud, many of which involved a misstatement of inventory amounts. These frauds have concealed financial distress or irregularities and have contributed to substantial economic losses by investors and creditors.

.85 Auditors should determine whether the audit plan is properly designed to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements. An evaluation of whether management may be inclined to misstate financial condition and operating results should carefully be made. In addition, it is essential that auditors are sensitive to the requirement to use a proper degree of professional skepticism and approach the audit in that manner.

.86 The following three sections are designed to provide auditors with—

1. An overview of their responsibility to detect fraud in accordance with GAAS.
2. Guidance on evaluating whether management may be inclined to intentionally misstate reported financial condition and operating results.
3. Examples of fraudulent misstatements related to inventory.

.87 *Responsibility to Detect Fraud.* Auditors should be fully aware of their responsibilities under SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities* (AU section 316). SAS No. 53 (AU section 316) requires the auditor to assess the risk that errors or irregularities may cause the financial statements to contain a material misstatement. Based on that assessment, the auditor should design the audit to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements. The Statement recognizes that "since the auditor's opinion on the financial statements is based on the concept of reasonable assurance, the auditor is not an insurer and his report does not constitute a guarantee."

.88 An auditor's responsibility to detect fraud should be set out in the engagement letter. The engagement letter should indicate, among other things, that an audit in conformity with GAAS ". . .require(s) that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement." The engagement letter should also indicate that "an audit is subject to the risk that material errors and irregularities, including fraud and defalcations, if they exist, will not be detected." These two statements convey the concept that, while the auditor must consider the risk that material instances of fraud could occur and design appropriate auditing procedures to mitigate that risk, the characteristics of fraud preclude the auditor from providing absolute assurance that all instances of material fraud will be detected, particularly if forgery or collusion is involved.

.89 If the risk that material errors and irregularities may exist is determined to be high, the auditor should revise the audit plan accordingly. Ordinarily, higher risk suggests a need to assign more experienced personnel to the engagement and to provide more supervision. Higher risk also suggests the need to expand the extent of audit procedures applied, to perform them closer to the balance sheet date, or to modify the nature of the procedures to obtain more persuasive evidence. Most important, higher risk should cause the auditor to exercise a heightened degree of professional skepticism when conducting the audit.

.90 *Management Predisposition to Fraud.* Most client managements are of unquestioned integrity and are forthright in responding to auditor inquiries and requests for information. However, as has been observed in the past, given sufficient *incentives* and *opportunity,* a very small number of entities may be inclined to intentionally misstate reported financial condition and operating results. Such incentives may include—

- A public or private placement of securities in process or contemplated in the near future.
- A substantial portion of executives' remuneration dependent on operating results.
- The entity being put up for sale.
- Management undertaking an aggressive program using the entity's stock as consideration.
- Indications that the entity will fall short of meeting its own and securities analysts' forecasts of earnings.

Examples of conditions that provide the opportunity include—

- A chief executive officer who dominates the entity's Board of Directors and others on his or her management team, seeks and receives a great deal of press, and is preoccupied with meeting and exceeding revenue and profit forecasts at all costs.
- A weak control environment as evidenced by a lack of concern for basic controls, a blatant disregard of auditor recommendations to improve controls, and weak accounting and financial personnel relative to the size and complexity of the entity. (Apart from any other considerations, this condition, particularly when prolonged, may warrant careful evaluation of whether to continue the client relationship.)

.91 Auditors should recognize that the presence of one or more of the above incentives and opportunities *alone* may not necessarily be cause for alarm. However, their presence along with the existence of certain other factors should raise concern. (Auditors may consider referring to Appendix F of the October 1987 *Report of the National Commission on Fraudulent Financial Reporting* [the Treadway Commission Report] for a discussion of "Good Practice Guidelines for Assessing the Risk of Fraudulent Financial Reporting.")

Examples of such factors include—

- Recent significant sales of the entity's stock by insiders.
- Reported allegations of management impropriety by employees.
- Recent changes in accounting principles that favorably impact reported earnings.
- Sale of real estate with complex or unusual terms.
- Unusually large increases in year-end sales to a single or a few customers.
- Dramatic increases in sales and receivables along with increases in gross profit margins totally inconsistent with past experience or industry averages.
- Certain sales of merchandise that are billed to customers prior to delivery and held by the seller (bill-and-hold transactions). The SEC's views on revenue recognition for bill-and-hold transactions are set forth in Accounting and Auditing Enforcement Release No. 108.
- Significant and unexpected increases in inventories (particularly *in-transit* inventories).
- Judgmental allowances (for example, bad debts, inventory obsolescence, or product warranty) consistently estimated at or near the low end of reasonableness.
- Delays in producing requested documents.
- Unusual and material related party transactions.
- A significant number of postclosing adjustments that increase reported income.

.92 When incentives, opportunities, and certain other factors are present, a heightened degree of skepticism should be brought to bear during the audit. Auditors must fully understand the substance of the transaction or event at issue, seek thorough explanations from management, and obtain appropriate evidence to corroborate management's explanations. In addition, consultation with others should occur whenever the audit team is unsure or does not fully understand the complexity of a particular transaction or event *and whenever a question arises about management's integrity.* Finally, for the high-risk areas of the audit, the audit scope should be expanded to reflect the audit team's skepticism, and the working papers should document the accounting and reporting issues in question, the procedures performed, and audit evidence obtained to support the conclusions.

.93 *Management Fraud Related to Inventory.* Recent media reports highlight inventory frauds that have resulted in material misstatements in financial statements. In planning and performing inventory procedures, auditors should be aware that reported methods of fraudulently misstating inventory have involved—

- Nonexistent items recorded as inventory.
- Goods that have been sold (and recorded as sales) included in inventory.
- Goods shipped between two sites and recorded as inventory at both locations.
- Scrap materials substituted for genuine inventory for the physical inventory observation.
- False invoices or entries.
- Inflated inventory costs.
- Inventory which has been excluded from the physical count because management states it has been sold when, under the terms of the bill-and-hold arrangement, title has not yet passed to the customer.
- Inadequate reserves for slow-moving and obsolete inventory.

The manner in which an entity's personnel have allegedly circumvented auditors with these frauds varies. In one instance, fictitious inventory count sheets are said to have been used to overstate inventory. In another case, client personnel were able to obtain knowledge of inventory test counts and inflate inventory quantities for items not tested. There have also been cases in which client personnel gained access to and altered auditor working papers documenting inventory test counts.

.94 Auditors should consider the guidance in SAS No. 1, *Codification of Auditing Standards and Procedures,* "Inventories" (AU section 331), and SAS No. 45, *Omnibus Statement on Auditing Standards—1983,* "Substantive Tests Prior to the Balance-Sheet Date" (AU section 313). Detailed guidance on planning, including assessing audit risk, and performing audit procedures related to inventories is included in the AICPA's APS, *Audit of Inventories* (Product No. 021045, $25). This APS includes chapters on such areas as planning inventory procedures, observation of an inventory count, valuation, and financial statement presentation and disclosure.

Significant Transactions or Events

.95 One of the most frequently cited sources of financial statement misstatement is the improper accounting for significant and unusual transactions or events, particularly those occurring at or near year-end. Auditors should carefully review all significant and unusual transactions or events to determine the appropriateness of any gain or loss recognized, any potential involvement with related parties and the collectibility or realization of receivables or other assets received as consideration. Examples of such transactions include—

- *Sale of real estate.* Real estate transactions have been the subject of numerous cases of fraudulent financial reporting. FASB Statement No. 66, *Accounting for Sales of Real Estate* (AC Re1), establishes standards for recognition of profit on *all real estate transactions* regardless of the nature of the seller's business.

- *Significant sale of assets.* Assets sold outside the ordinary course of business may involve a related party, a buyer without substance, or collection of a receivable contingent upon the success of the buyer's future operations.

- *Unusual year-end sales to new customers.* Year-end sales (especially those to new customers) of merchandise that was previously considered obsolete or slow-moving could indicate the existence of possible side agreements offering the right of return, consignment of shipments, shipments recorded as sales prior to transfer of title, or outright fictitious sales.

Dispute Resolution With Audit Staff

.96 The first standard of fieldwork requires that audit fieldwork be properly planned and supervised. As discussed in SAS No. 22, *Planning and Supervision* (AU section 311), the auditor with final responsibility for the audit should direct assistants to bring to his or her attention significant accounting and auditing questions raised during the audit so that he or she may assess their significance. The auditor with final responsibility for the audit should be aware of the procedures to be followed when differences of opinion concerning accounting and auditing issues exist among firm personnel involved in the audit. Such procedures should enable an assistant to document his or her disagreement with the conclusions reached if, after appropriate consultation, he or she believes it is necessary to disassociate himself from the resolution of the matter. The basis for the final resolution should also be documented.

.97 Failure of an auditor to disassociate from an audit when, in his or her opinion, the financial statements are not in accordance with GAAP or the audit evidence is insufficient, and these facts have not been communicated in the auditor's report, constitutes improper professional conduct and may lead to legal actions. As indicated by the SEC in Accounting and Auditing Enforcement Release No. 455:

> An independent accountant, including an audit manager, cannot excuse his failure to comply with GAAS because of a sense of futility after his proposed approaches to certain accounting issues are repeatedly rejected. Similarly, such failure cannot be excused by

pointing to pressure, whether from clients or partners. An audit manager has a crucial role in the day to day conduct of the audit which includes supervision and review of the work of the audit staff and advising and consulting with the audit firm's partners and client's management. In performing those roles, the audit manager may encounter pressure to compromise audit standards and may encounter frustration in dealing with partners and clients. The audit manager may also sense that his response to those pressures may adversely affect his opportunity for advancement. However, in fulfilling his responsibilities, the audit manager plays a crucial role in ensuring that an audit report is issued only when the audit was in fact conducted in accordance with GAAS.

Legal Letters

.98 SAS No. 12 (AU section 337) requires that a written inquiry be made of a client's lawyer concerning litigation, claims, and assessments. The lawyer's response to that inquiry serves as the principal support for management's representations concerning these matters.

.99 Auditors should keep the following in mind when performing procedures related to litigation, claims, and assessments:

- Legal responses should be dated as close as possible to the date of the auditor's report. In situations in which attorneys' letters are dated substantially in advance of the date of the auditor's report, an updated response should be obtained, as required by SAS No. 12 (AU section 337).

- When evaluating lawyers' responses, auditors should be satisfied that the requirements of FASB Statement No. 5 (AC C59) have been appropriately applied and all necessary related disclosures have been made. Auditors should refer to Interpretation No. 7 of SAS No. 12, "Assessment of a Lawyer's Evaluation of the Outcome of Litigation" (AU section 9337.18-.23), for an understanding of how to relate lawyers' responses to the three probability classifications established for loss contingencies in FASB Statement No. 5 (AC C59). The auditor should also evaluate whether, because of an uncertainty related to pending litigation or other legal contingency, an uncertainty paragraph should be added to the auditor's report.

- If the client has *not* consulted a lawyer during the audit period, the auditor should reflect that by appropriately modifying the client representation letter.

Confirmation From Third Parties

.100 In the course of performing an audit, auditors may use confirmations to obtain evidence from third parties about financial assertions made by management. As discussed in SAS No. 67, *The Confirmation Process* (AU section 330), in determining the degree of reliance to place on the evidence provided by confirmations, the auditor should assess whether the confirmations reduce the audit risk of the assertion to an acceptably low level. In making that assessment, the auditor should consider the materiality of the balance and the inherent and control risks associated with assertions. If the balances are material and the transactions from which they arose are unusual, complex, or outside the normal course of business, the auditor should evaluate carefully the degree of reliance placed on third party confirmations and consider the possibility of collusion or negligence by the third party. The auditor should exercise the appropriate level of professional skepticism in designing, performing, and evaluating the results of confirmation procedures and should not place undue reliance on confirmation evidence in circumstances of high risk. When the auditor concludes that evidence produced by the confirmation is not sufficient, additional procedures should be performed.

Compliance With Loan Covenants

.101 Lenders are closely monitoring the quality of their loan portfolios, particularly loans to highly leveraged borrowers. These lenders may be reluctant to grant waivers for loan covenant violations that cannot be quickly cured. When it is likely that an entity (borrower) will not meet projected goals, auditors should perform the debt-compliance review early so if instances of noncompliance are noted, the entity's management has sufficient time to seek waivers from lenders. Because of the attention to debt compliance by lenders and other users of financial statements, auditors should carefully review the adequacy of the disclosures in the notes to the financial statements related to loan covenants, which if violated could allow a lender to call the loan.

.102 If an entity is in violation of a debt covenant at year-end, the related debt should be classified as a current liability. FASB Statement No. 78, *Classification of Obligations That Are Callable by the Creditor* (AC B05), specifies the balance-sheet classification of long-term obligations that are callable by the creditor. In accordance with the Statement, when a debtor's violation of a provision of a debt agreement at the balance-sheet date makes the obligation callable, the debt may only continue to be classified as a long-term liability if (1) the creditor waives or subsequently loses the right to demand repayment for more than one year from the balance-sheet date or (2) the obligation contains a grace period within which the debtor may cure the violation and it is probable the violation will be cured.

.103 Auditors should obtain sufficient competent evidence to support long-term classifications in these situations. An oral agreement by a bank, in terms of a waiver of a covenant violation, is not considered sufficient competent audit evidence to classify the debt as noncurrent. If a written waiver is obtained subsequent to completion of the auditor's fieldwork but prior to issuance of the auditor's report and it is considered sufficient audit evidence to classify the debt as noncurrent, the auditor's report should be dated in accordance with SAS No. 1, *Codification of Auditing Standards and Procedures,* "Dating of the Independent Auditor's Report" (AU section 530). The auditor has two methods available for dating the report: (1) dual-dating or (2) dating the report as of the later date with an extension of the auditor's subsequent events procedures.

.104 Refinanced debt classified as noncurrent in the current year, which was classified as current debt in the previously issued prior year financial statements should not be reclassified as noncurrent in a comparative financial statement presentation. It is not appropriate to reclassify debt for events occurring subsequent to the initial issuance of an auditor's report.

Considering or Accepting Employment With a Client

.105 The AICPA Code of Professional Conduct (ET section 191.154) requires that an individual who is offered employment by, or seeks employment with, a client during the conduct of an engagement must consider whether or not his or her ability to act with integrity and objectivity has been impaired. If the engagement requires independence, the individual must remove himself or herself from the engagement until the employment offer is rejected or employment is no longer being sought, in order to prevent any appearance that integrity or objectivity has been impaired.

.106 An auditor may become aware that an individual participated in an engagement while employment with the client was being considered or after it had been accepted. The auditor should consider what, if any, additional procedures may be necessary to ensure that all work had been performed with integrity and objectivity, as required under Rule 102 of the AICPA Code of Professional Conduct (ET section 102.01). Any additional procedures will depend on the nature of the engagement and may require reperformance of the work or other appropriate procedures.

Recurring Peer and Quality Review Comments

.107 This section sets forth certain reminders to auditors based on frequently recurring comments noted in peer and quality review letters of comment. Many of the items discussed below were discussed in last year's alert; however, the problems continue to occur.

Audit Risk and Materiality

.108 SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AU section 312), requires the auditor to consider audit risk and materiality both in (1) planning the audit and designing auditing procedures and (2) evaluating whether the financial statements taken as a whole are presented fairly in all material respects in conformity with GAAP. Consideration of audit risk includes assessing inherent risk and control risk, as defined in SAS No. 47 (AU section 312).

Written Audit Programs

.109 SAS No. 22 (AU section 311) requires the auditor, in planning all audits, to consider the nature, timing, and extent of work to be performed and to prepare a written audit program. An audit program is required in every auditing engagement. The audit program should set forth in reasonable detail the audit procedures that the auditor believes are necessary to accomplish the objectives of the audit. The audit program should also be tailored to include audit considerations particular to the entity.

Consideration of the Internal Control Structure

.110 SAS No. 55 (AU section 319) requires the auditor to *obtain and document* a sufficient understanding of the three elements of an internal control structure—the control environment, the accounting system, and control procedures. After obtaining this understanding, the auditor should assess control risk for the assertions embodied in the financial statements. These requirements apply even if the auditor does not intend to rely on the internal control structure to reduce substantive tests. If the auditor seeks to reduce control risk to a level at which substantive tests may be reduced, he or she should perform tests of control as discussed in SAS No. 55 (AU section 319).

Analytical Procedures

.111 SAS No. 56, *Analytical Procedures* (AU section 329), requires auditors to apply analytical procedures during the planning and review stages of all audits. In addition, the auditor may use analytical procedures as substantive tests to obtain evidential matter about particular assertions related to account balances or classes of transactions. When analytical procedures are used as substantive tests, SAS No. 56 (AU section 329) requires the *auditor to develop expectations* for those assertions being tested.

Representation Letters

.112 SAS No. 19, *Client Representations* (AU section 333), establishes a requirement that the independent auditor obtain written representations from management as part of an audit performed in accordance with GAAS. Auditors should obtain a client representation letter in every audit.

Communication of Internal Control Structure Related Matters

.113 SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* (AU section 325), requires auditors to report, preferably in writing, matters considered to be reportable conditions. If the information is communicated orally, auditors *are required* to document the communication in the working papers.

Communication With Audit Committees

.114 SAS No. 61, *Communication With Audit Committees* (AU section 380), requires auditors to communicate certain matters to those who have responsibility for oversight of the financial reporting process (for example, an audit committee). The auditor is only required to make these communications in audits of (1) entities that either have an audit committee or have otherwise formally designated oversight of the financial reporting process to a group equivalent to an audit committee and (2) all SEC engagements (as defined). Therefore, in audits of most nonpublic smaller companies that have a Board of Directors only, the auditor may, but is not required to, make these communications. This communication may be oral or written. If information is communicated orally, the auditor should document the communication by appropriate memoranda or notations in the working papers. When those matters that are required to be communicated do not apply to a particular engagement (for example, there were no disagreements with management), documentation is not necessary because there was no communication required.

Working Paper Requirements

.115 Peer and quality reviews continue to identify deficiencies in working papers. In some circumstances, reviews have noted an absence of working papers or inappropriate or incomplete working paper content. SAS No. 41 (AU section 339) provides auditors with guidance on the functions, nature, content, ownership, and custody of working papers.

.116 Auditors should ensure that the working papers are sufficient to show that the accounting records agree or reconcile with the financial statements or other information being reported on *and* that the standards of fieldwork have been observed.

.117 SAS No. 41 (AU section 339) states that working papers should ordinarily include documentation showing that—

- The work has been adequately planned and supervised.
- A sufficient understanding of the internal control structure has been obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.
- The audit evidence obtained, the auditing procedures applied, and the testing performed have provided sufficient competent evidential matter to afford a reasonable basis for an opinion.

Auditors should recognize that certain SASs contain *specific* documentation requirements that are summarized in footnote 2 of SAS No. 41 (AU section 339.01). In addition, auditors performing engagements under *Government Auditing Standards* are reminded to refer to those standards for certain additional requirements for working papers.

Review of Working Papers

.118 Auditors are required to exercise due professional care in their audit engagements. Due professional care entails a thorough and complete review of the audit working papers and appropriate documentation of that review. SAS No. 22 (AU section 311) establishes a requirement that work performed by each assistant be reviewed.

.119 For many audits, this review includes both a detailed review of the work performed by staff *and* a higher level supervisory review of the working papers taken as a whole. Use of a "reviewer's checklist" can assist in ensuring that the reviewer followed firm policy during his or her performance of the review. However, review notes or "to do" points should be ordinarily discarded after they have been resolved or "cleared."

Incomplete Financial Statement Disclosures

.120 SAS No. 32, *Adequacy of Disclosure in Financial Statements* (AU section 431), sets forth the auditor's responsibility to ensure that audited financial statements include disclosures required by GAAP. This is most effectively accomplished through use of disclosure checklists and review of the financial statements by someone not otherwise associated with the engagement. Some of the more common disclosure deficiencies noted in peer reviews relate to disclosure requirements set forth in—

- FASB Statement No. 47, *Disclosure of Long-Term Obligations* (AC C32). For example, the Statement requires disclosure of the combined aggregate amount of maturities for each of the five years following the date of the latest balance sheet presented.
- FASB Statement No. 95, *Statement of Cash Flows* (AC C25). For example, the Statement requires disclosure of the accounting policy for determining what items are treated as cash equivalents and when the indirect method is used, amounts of interest paid and income taxes paid during the period.
- FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (AC F25). Auditors should be aware that many entities other than financial institutions have concentrations of credit risk. For example, an entity that has material bank accounts above the insured limit at one bank should disclose a concentration of credit risk at that bank.

Other common disclosure deficiencies relate to leases, income taxes, capital stock, related-party transactions, and pension or profit-sharing plans.

Lessons From Litigation

Working Paper Retention Policies

.121 Auditors are required to maintain their audit working papers to document that the audit evidence obtained, the auditing procedures applied, and the testing performed have provided sufficient competent evidential matter to support the audit opinion (AU section 339). It has become apparent, as a result of the litigation explosion, that audit working papers have another function: to assist would-be claimants to prove that auditors acted in an inappropriate manner.

.122 Auditors should carefully consider this second function of their working papers when formulating (or revising) firm working paper retention policies. In establishing a working paper retention policy, there are certain basic rules that firms should follow: [2]

- The document retention period should be sufficiently long to (1) negate an inference that it was designed to destroy information that could subsequently injure the firm, and (2) satisfy the auditor's reasonable needs to obtain information regarding the entity's prior financial activities.
- The document retention period should be rational in the sense that a longer retention period should be maintained for documents which are likely to be called upon at a later date.
- The document retention policy should be scrupulously adhered to so as to avoid an inference that documents were destroyed because they were the subject of litigation.

[2] For further information on this topic, contact the American Society of Accountants (ASA), a malpractice insurance company, at (800) 343-5079, to obtain a copy of "Document Retention Policies," published in the Winter 1993 issue of the ASA's *Risk Management Newsletter*. In addition, the AICPA's *Management of an Accounting Practice Handbook* provides guidance on working paper retention. Copies may be obtained by contacting Practitioners Publishing Company at (800) 323-8724.

Client Acceptance and Retention Policies

.123 Past experience in auditor litigation has proven that one of the principal factors giving rise to liability claims against auditors is *problem clients.* Firms should devise a formal client acceptance/retention policy to assist them in evaluating whether to accept, reject, or retain a client. Auditors must carefully distinguish between those clients that possess certain undesirable qualities from those that possess a *significant* number of undesirable qualities making client representations inherently unreliable.

.124 Acceptance or retention of a client engagement may be potentially dangerous when the auditor identifies client characteristics including—

- Management that lacks integrity.
- Weak financial condition.
- Unwillingness to pay professional service fees.
- Management that jeopardizes the entity's continued existence by entering into material high-risk transactions.
- Disregard for internal controls and recordkeeping.
- Management that refuses to sign engagement and representation letters.

As part of this evaluation, auditors must carefully evaluate a client's characteristics and, in some instances, may need to conclude that servicing a client may be too risky a venture.[3]

Accounting Issues and Developments

Losses Resulting From Catastrophic Events

.125 Losses resulting from catastrophic events have reached record proportions and natural disasters continue to cause damage that results in significant financial loss. Judgment is required to determine the appropriate income statement presentation of losses arising from catastrophic events. APB Opinion No. 30 (AC I13) discusses the criteria for reporting extraordinary items in the income statement. Only in rare circumstances does an event—even a catastrophic event—meet both the *unusual nature* and *infrequency of occurrence* criteria of APB Opinion No. 30 (AC I13) for extraordinary item treatment. In most cases, losses stemming from natural catastrophes do not meet the second criterion—infrequency of occurrence. Events such as hurricanes, tropical storms, winter storms, and floods from heavy rains, generally are not *infrequent,* since they are reasonably expected to recur in the foreseeable future in the environment in which the entity operates. Therefore, it generally is not appropriate to report losses arising from such events as extraordinary items.

Postemployment Benefits

.126 In November 1992, the FASB issued Statement No. 112, *Employers' Accounting for Postemployment Benefits* (AC P32), to establish accounting standards for entities that provide former or inactive employees postemployment benefits. The Statement is effective for fiscal years beginning after December 15, 1993.

.127 Postemployment benefits include, but are not limited to, salary continuation, supplemental unemployment benefits, severance benefits, disability-related benefits, job training and counseling, and continuation of

[3] For further information on this topic, contact the American Society of Accountants (ASA) at (800) 343-5079 to obtain a copy of "Client Retention Policies," published in the Winter 1993 issue of the ASA's *Risk Management Newsletter.* In addition, the AICPA's *Management of an Accounting Practice Handbook* provides guidance on client acceptance and retention. Copies may be obtained by contacting Practitioners Publishing Company at (800) 323-8724. The AICPA's publication *Managing the Malpractice Maze* (Product No. 090380) also provides guidance on this topic (chapter 10, "Client Screening").

health care benefits and life insurance benefits. The Statement requires that entities accrue an obligation to provide postemployment benefits if all of the following conditions are met:

- The obligation is attributable to employees' services already rendered.
- Employees' rights to those benefits accumulate or vest.
- Payment of the benefits is probable.
- The amount of the benefits can be reasonably estimated.

.128 If all of the above conditions are not met, entities should follow the guidance in FASB Statement No. 5 (AC C59) and accrue postemployment benefits when it is probable that a liability has been incurred and the amount can reasonably be estimated. If an obligation for postemployment benefits is not accrued in accordance with these requirements only because the amount cannot be reasonably estimated, the entity should disclose that fact in the financial statements.

Postretirement Benefits Other Than Pensions

.129 In December 1990, the FASB issued Statement No. 106 (AC P40). Although it applies to all forms of postretirement benefits other than pensions, Statement No. 106 (AC P40) focuses principally on postretirement health care benefits. The Statement is effective for fiscal years beginning after December 15, 1992, with a two-year delayed effective date for plans outside the U.S. and certain small nonpublic employers. (The FASB has issued *A Guide to Implementation of Statement 106 on Employers' Accounting for Postretirement Benefits Other Than Pensions.* This publication is available from the FASB, (203) 847-0700, ext. 10; Product No. PQA106; $10.50.)

.130 The audit approach to OPEB is similar to the audit of pension costs and obligations because both require actuarial calculations. Therefore, auditors will generally need to follow the auditing requirements of SAS No. 11 (AU section 336). In accordance with SAS No. 11 (AU section 336), auditors should make appropriate tests of data provided by the client to the actuary. Because postretirement benefit costs are dependent on future events, auditors should also consider the guidance in SAS No. 57 (AU section 342).

.131 For additional discussion of what auditors should consider when auditing amounts required by Statement No. 106 (AC P40), see "Auditing Postretirement Benefits: How to Deal with FASB 106" in the August 1992 *Journal of Accountancy.* Also, the November 1992 issue of the *Journal of Accountancy* includes the sample standard confirmation request for auditors to send to the client's actuary.

Income Taxes

.132 In February 1992, the FASB issued Statement No. 109, *Accounting for Income Taxes* (AC I27), which is effective for fiscal years beginning after December 15, 1992. (The FASB has issued *A Guide to Implementation of Statement 109 on Accounting for Income Taxes.* The publication is available from the FASB, (203) 847-0700, ext. 10; Product No. TQA109; $10.50.) FASB Statement No. 109 (AC I27) requires an asset and liability approach for financial accounting and reporting for income taxes. It requires recognition of (1) current tax liabilities or assets for the estimated taxes payable or refundable on tax returns for the current year, and (2) deferred tax liabilities or assets for the estimated future tax effects attributable to temporary differences and tax operating loss and credit carryforwards.

.133 Implementation of the new standard raises some unique issues, such as the valuation allowance for any deferred tax asset and the change in deferred tax provisions that arise from enactment of the Omnibus Budget Reconciliation Act of 1993 (the Act), signed into law on August 10, 1993. The effect of the change in tax laws and rates included in the Act on taxes for the current year should be recognized in the period that includes the enactment date (third quarter for calendar-year entities). As such, the effect is a component of the income tax provision attributable to continuing operations and should not be presented on the face of the statement of operations in any manner that would imply anything else.

.134 Statement No. 109 (AC I27) requires that deferred tax assets be recognized for temporary differences that will result in deductible amounts in the future and for carryforwards. A deferred tax valuation allowance must be established if it is *more likely than not* that all or a portion of the deferred tax assets will not be realized. The judgment about the need for a valuation allowance depends on each entity's specific facts and circumstances; there are no precise formulas for determining whether a valuation allowance is needed, or the amount of the allowance. Such need is based on an assessment of the likelihood of the entity's ability to generate sufficient taxable income of the appropriate character (for example, ordinary income or capital gain) within the carryback or carryforward period under the applicable tax law to realize the tax benefits recognized as a result of deductible temporary differences, operating loss carryforwards, and tax credit carryforwards.

.135 Auditors should comply with the requirements of SAS No. 57 (AU section 342) by considering all available evidence, both positive and negative, to determine whether, on the basis of that evidence, a valuation allowance is needed. The weight given to the potential effect of positive and negative evidence should be commensurate with the extent to which it can be objectively verified. The more negative evidence that exists, the more positive evidence is necessary and the more difficult it is to support a conclusion that a valuation allowance is not needed for some or all of the deferred tax asset.

.136 In the year of adopting Statement No. 109 (AC I27), an explanatory paragraph regarding consistency should be added to the auditor's report when the effect of such change in accounting principle on the comparability of the financial statements is material. See SAS No. 58 (AU section 508.34).

.137 The EITF has addressed several issues related to income taxes. Reference should be made to *EITF Consensus Positions* in the "Other Pronouncements" section, paragraph .157 of this Alert.

.138 The SEC staff is reviewing income tax disclosures, both in the notes to the financial statements and in MD&A. In circumstances where deferred tax assets comprise a significant portion of the entity's stockholders' equity and it is not apparent that the entity's existing level of income would be sufficient to realize the deferred tax assets, the SEC staff may question management about its conclusion regarding the realizability of the deferred tax assets.

.139 If realization of a material deferred tax asset will require material improvements in profitability, material changes in trends, material changes in the relationship between reported pretax income and federal taxable income, material asset sales, or similar nonroutine transactions, the SEC staff indicates that a discussion in MD&A of these factors is necessary to provide adequate disclosure regarding the nature of the asset. The SEC staff believes that entities should provide sufficient disclosures in MD&A to inform the reader what factors and assumptions led management to arrive at its conclusion that the deferred tax asset would be realized.

Impairment of Loans

.140 In May 1993, FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan* (AC I08), was issued. This Statement applies to financial statements for fiscal years beginning after December 15, 1994. Earlier application is encouraged. The Statement *is applicable to all creditors, not just financial institutions,* and to all loans, uncollateralized as well as collateralized. Large groups of smaller-balance homogeneous loans collectively evaluated for impairment and loans measured at fair value or at the lower of cost or fair value are among the exceptions to this Statement.

.141 The Statement amends FASB Statement No. 5 (AC C59) to clarify that a creditor should evaluate the collectibility of both contractual interest and contractual principal of all receivables when assessing the need for a loss accrual. The Statement also amends FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings* (AC D22), to require that a creditor measure all loans restructured in a troubled debt restructuring involving a modification of terms in accordance with its provisions.

.142 A loan, according to FASB Statement No. 114 (AC I08), is a contractual right to receive money on demand or on fixed or determinable dates that is recognized as an asset in the creditor's statement of financial position. Examples include, but are not limited to, accounts receivable (with terms exceeding one year) and notes receivable. A loan is impaired when it is probable that a creditor will be unable to collect all amounts due (including both the contractual interest payments and the principal payments) according to the terms of the loan agreement. Statement No. 114 (AC I08) requires that impaired loans within its scope be measured on the basis of the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loan's observable market price or the fair value of collateral if the loan is collateral-dependent.

.143 The term *probable* (consistent with its use in FASB Statement No. 5 [AC C59]) means that the future event or events are likely to occur. According to Statement No. 5 (AC C59), the conditions for accrual are not inconsistent with the accounting concept of conservatism. *Those conditions are not intended to be so rigid that they require virtual certainty before a loss is accrued.* They require only that it be *probable* that an asset has been impaired or a liability has been incurred and that the amount of loss be *reasonably* estimable. Auditors should refer to SAS No. 57 (AU section 342) for guidance on auditing these amounts.

.144 Auditors should carefully consider the audit risk implications of applying the new provisions of the Statement. Aspects of applying the new Statement that warrant particular consideration include—

- Proper identification of all loans to which the Statement should be applied.
- The reasonableness of estimates of future cash flows and interest rates used in discounting.
- The appropriateness of amounts used to measure impairment if alternatives to present-value amounts (such as fair values of collateral or observable market prices) are used.

.145 The applicable auditing guidance includes SAS No. 11 (AU section 336) and SAS No. 57 (AU section 342). In addition, auditors may find it useful to refer to the APS, *Auditing the Allowance for Credit Losses of Banks* (Product No. 021050EK; $25), as a source of information useful in identifying loans for evaluation and developing an effective audit approach.

Investments in Securities

.146 In May 1993, the FASB issued Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (AC I80), which is effective for fiscal years beginning after December 15, 1993. It specifically prohibits retroactive restatement of prior financial statements. Although, typically, Statement No. 115 (AC I80) would be initially applied as of the beginning of a fiscal year (such as January 1, 1994), entities are permitted to initially apply the Statement as of the end of an earlier annual period for which financial statements have not yet been issued (with no restatement of interim periods). The new statement supersedes FASB Statement No. 12, *Accounting for Certain Marketable Securities* (AC I89), and its related interpretations. *Statement No. 115* (AC I80) *will impact almost all business enterprises.* The greatest effect, however, is expected to be on financial entities. The Statement covers all debt securities, as well as the marketable equity securities previously addressed by Statement No. 12 (AC I89). Not covered are securities accounted for by the equity method and investments in consolidated subsidiaries.

.147 Statement No. 115 (AC I80) establishes the following three categories of reporting debt and marketable equity securities:

- *Held-to-maturity securities* (debt securities that the entity has the positive intent and ability to hold to maturity), to be reported at amortized cost
- *Trading securities* (debt and equity securities that are bought and held principally for the purpose of selling them in the near future), to be reported at fair value, with unrealized gains and losses included in earnings

- *Available-for-sale securities* (debt and equity securities not classified as either held-to-maturity or trading), to be reported at fair value, with unrealized gains and losses excluded from earnings and reported in a separate component of equity until realized

An entity should not classify a debt security as held-to-maturity if the enterprise has the intent to hold the security for only an indefinite period. Consequently, a debt security should not, for example, be classified as held-to-maturity if the enterprise anticipates that the security would be available for sale in response to changes in market interest rates and related changes in the security's prepayment risk, needs for liquidity, changes in the availability of and the yield on alternative investments, changes in funding sources and terms, or changes in foreign currency risk.

.148 Paragraph 8 of the Statement (AC I80.105) indicates that certain changes in circumstances may cause the enterprise to change its intent to hold a certain security to maturity without calling into question its intent to hold other debt securities to maturity in the future. Such circumstances include evidence of a significant deterioration in the issuer's creditworthiness or a change in tax law that eliminates or reduces the tax-exempt status of interest on the debt security. In addition, other events that are isolated, nonrecurring, and unusual for the reporting enterprise that could not have been reasonably anticipated may cause an entity to sell or transfer a held-to-maturity security without necessarily calling into question its intent to hold other debt securities to maturity. Such sales and transfers of held-to-maturity securities are expected to be rare.

.149 In discussing the impairment of securities other than trading securities, Statement No. 115 (AC I80) indicates that if the decline in an individual security's fair value is judged to be other than temporary, its cost basis must be written down to fair value, which becomes the new cost basis. The amount of the write-down is included in earnings. If it is probable that the investor will be unable to collect all amounts due (principal and interest) according to the contractual terms of a debt security not impaired at acquisition, an other-than-temporary impairment is considered to have occurred.

.150 Since all entities with a calendar fiscal year must classify their investments in securities in accordance with Statement No. 115 (AC I80) as of January 1, 1994, those entities will also be able to apply the Statement as of December 31, 1993 if they wish to do so in their 1993 annual financial statements. Thus, auditors should be aware of how those financial statements involving the classification of investments in debt and equity securities pursuant to Statement No. 115 (AC I80) will require judgment about such matters as—

- The subjective exceptions for sales of securities designated as held-to-maturity (including the interpretation of restrictive terms such as *isolated, nonrecurring,* and *unusual*).
- The ability of an entity to hold securities to maturity, particularly when going-concern issues arise.
- Whether cash flow projections are needed in conjunction with assessing an entity's ability to hold securities to maturity.
- How to evaluate whether impairments of investments are other-than-temporary.

Contributions Received and Made

.151 In June 1993, the FASB issued Statement No. 116, *Accounting for Contributions Received and Contributions Made* (AC C67). The Statement is effective for financial statements issued for fiscal years beginning after December 15, 1994, with earlier application encouraged. Statement No. 116 (AC C67) establishes accounting standards for contributions and *applies to all entities that receive or make contributions.* With issuance of this Statement, the FASB has specified when and on what basis contributions should be recognized by both contributors and recipients. The Statement defines a *contribution* (avoiding the term *pledge*) as "an unconditional transfer of cash or other assets . . . or a settlement or cancellation of its liabilities in a voluntary nonreciprocal transfer . . ." Generally, contributions received, including unconditional promises to give, are recognized as revenues in the period received at their fair values. Contributions made, including unconditional promises to give, are recognized as expenses in the period made at their fair values. Conditional promises to give, whether received or made, are recognized when they become unconditional, that is, when the conditions are substantially met.

.152 A typical auditor "search for unrecorded liabilities" may not detect such "promises to give." Therefore, review of documents such as the minutes of the Board of Directors meetings may assist auditors in identifying such promises and evaluating whether proper accrual has been made by a contributor.

Industry Developments

.153 The AICPA issues *Audit Risk Alerts* that focus on recent developments in various industries to provide auditors with overviews of current economic, industry, regulatory, and professional developments. The following industries are covered:

- Agribusiness (AAM section 8080)
- Banks and Savings Institutions (AAM section 8050)
- Common Interest Realty Associations (AAM section 8100)
- Construction Contractors (AAM section 8120)
- Credit Unions (AAM section 8020)
- Employee Benefit Plans (AAM section 8060)
- Federal Government Contractors (AAM section 8130)
- Finance Companies (AAM section 8140)
- Health Care (AAM section 8030)
- High-Technology Enterprises (AAM section 8200)
- Insurance Companies (AAM section 8040)
- Investment Companies (AAM section 8150)
- Not-for-Profit Organizations (AAM section 8180)
- Oil and Gas Producers (AAM section 8160)
- Real Estate Companies (AAM section 8210)
- Securities (AAM section 8170)
- State and Local Governments (AAM section 8070)

.154 This year the AICPA has issued a special edition *Audit Risk Alert* titled *FDIC Improvement Act Implementation Issues* [AAM section 8190] that informs auditors how the FDIC Improvement Act of 1991 and its implementing regulations and guidelines affect the engagements they perform.

.155 Copies of these industry updates are available from the AICPA Order Department, (800) TO-AICPA, at a cost of six dollars each and are also included in the loose-leaf service for audit and accounting guides.

Auditing Standards Division Publications

.156 The following publications are issued by the Auditing Standards Division and are available from the AICPA Order Department, (800) TO-AICPA. Product numbers and prices are shown in parentheses.

Codification of Statements on Auditing Standards (includes SAS Nos. 1-71 as well as SSAEs) (059023, $50)

Selected Auditing Procedures Studies (nonauthoritative documents issued to inform auditors of developments and advances in auditing procedures and to provide practical assistance)

Audit Considerations in Common Computer Environments[4]

Auditing the Allowance for Credit Losses of Banks (021050EK, $25)

Auditing With Computers[4]

Audit of Inventories (021045EK, $25)

Auditors' Use of Microcomputers (021030EK, $25)

Confirmation of Accounts Receivable (021011EK, $25)

Implementing SAS No. 70, Reports on the Processing of Transactions by Service Organizations[4]

The Independent Auditor's Consideration of the Work of Internal Auditors (021051EK, $25)

Other Pronouncements

.157 Following is a list of various authoritative pronouncements issued from January 1, 1993, to November 1, 1993, and their effective dates.

Statements of Financial Accounting Standards and Interpretations Issued by the FASB[5]

To order copies, call the FASB at (203) 847-0700, ext. 10.

	Description	*Effective Date*
FASB No. 114 (May 1993)	*Accounting by Creditors for Impairment of a Loan* (AC I08)	Financial statements for fiscal years beginning after December 15, 1994
FASB No. 115 (May 1993)	*Accounting for Certain Investments in Debt and Equity Securities* (AC I80)	Fiscal years beginning after December 15, 1993 (to be initially applied as of the beginning of an enterprise's fiscal year and cannot be applied retroactively)
FASB No. 116 (June 1993)	*Accounting for Contributions Received and Contributions Made* (AC C67)	Financial statements issued for fiscal years beginning after December 15, 1994, except for not-for-profit organizations with less than $5 million in total assets and less than $1 million in annual expenses (for those organizations, the Statement is effective for fiscal years beginning after December 15, 1995)
FASB No. 117 (June 1993)	*Financial Statements of Not-for-Profit Organizations* (AC No5)	Annual financial statements issued for fiscal years beginning after December 15, 1994, except for organizations with less than $5 million in total assets and less than $1 million in annual expenses (for those organizations, the Statement is effective for fiscal years beginning after December 15, 1995)
Interpretation No. 40 (April 1993)	*Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises* (AC In6)	Financial statements issued for fiscal years beginning after December 15, 1994, except for the disclosure provisions, which are effective for fiscal years beginning after December 15, 1992

EITF Consensus Positions

To order copies, call the FASB at (203) 847-0700, ext. 10.

[4] Expected to be published in the first quarter of 1994. A product number is not available at this time.

[5] See *State and Local Governmental Developments—1993* [AAM section 8070] for recently issued Statements of the Governmental Accounting Standards Board.

	Description	Date Position Reached
92-12	*Accounting for OPEB Costs by Rate-Regulated Enterprises*	January 21, 1993
93-1	*Accounting for Individual Credit Card Acquisitions*	May 20, 1993
93-2 [6]	*Effect of Acquisition of Employer Shares for/by an Employee Benefit Trust on Accounting for Business Combinations*	January 21, 1993
93-3	*Plan Assets Under FASB Statement No. 106*	January 21, 1993
93-4	*Accounting for Regulatory Assets*	March 16, 1993
93-5	*Accounting for Environmental Liabilities*	May 20, 1993
93-6	*Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises*	July 22, 1993
93-7	*Uncertainties Related to Income Taxes in a Purchase Business Combination*	March 16, 1993
93-8	*Accounting for the Sale and Leaseback of an Asset That Is Leased to Another Party*	July 22, 1993
93-9	*Application of FASB Statement No. 109 in Foreign Financial Statements Restated for General Price-Level Changes*	September 23, 1993
93-10 [6]	*Accounting for Dual Currency Bonds*	September 23, 1993
93-12	*Recognition and Measurement of the Tax Benefit of Excess Tax-Deductible Goodwill Resulting from a Retroactive Change in Tax Law*	September 23, 1993
93-13	*Effect of a Retroactive Change in Enacted Tax Rates That Is Included in Income from Continuing Operations*	September 23, 1993

Statements of Position Issued by the AICPA [*]

To order copies, call the AICPA at (800) TO-AICPA. Product numbers and prices are shown in parentheses.

Description		Effective Date
SOP No. 93-1 (January 28, 1993)	*Financial Accounting and Reporting for High-Yield Debt Securities by Investment Companies* (014876, $6)	Financial statements and for audits of such financial statements for fiscal years ending after December 15, 1993, and for interim periods within such years
SOP No. 93-2 (February 1, 1993)	*Determination, Disclosure, and Financial Statement Presentation of Income, Capital Gain, and Return of Capital Distributions by Investment Companies* (014877, $6)	Annual financial statements for fiscal years ending after December 15, 1993, and for interim statements for periods in such years
SOP No. 93-3 (March 19, 1993)	*Rescission of Accounting Principles Board Statements* (014878, $6)	Upon Issuance
SOP No. 93-4 (April 22, 1993)	*Foreign Currency Accounting and Financial Statement Presentation for Investment Companies* (014874, $6)	Financial statements for fiscal years beginning after December 15, 1993, and interim periods within such years

[6] Because of the SEC staff's position on this matter, the EITF did not reach a consensus on the issue.

[*] Note: SOP No. 93-6, *Employers' Accounting for Employee Stock Ownership Plans* (014803, $6), is expected to be issued November 22, 1993. The SOP is effective for fiscal years beginning after December 15, 1993, (refer to the SOP for certain transition provisions). The AICPA plans to issue the following two SOPs in December 1993 (at this time, product numbers for these SOPs are not available):

- *Inquiries of Representatives of State Insurance Regulators* (effective for audits of financial statements for periods ending on or after December 15, 1994)
- *The Auditor's Consideration of Regulatory Risk-Based Capital for Life Insurance Enterprises* (effective for audits of life insurance enterprises' financial statements for periods ending after December 15, 1993)

In addition, in January 1994, the AICPA plans to issue an SOP titled *Reporting on Advertising Costs.* (At this time, a product number is not available.) The SOP will be effective for financial statements for fiscal years beginning after June 15, 1994.

Description		Effective Date
SOP No. 93-5 (April 23, 1993)	*Reporting on Required Supplementary Information Accompanying Compiled or Reviewed Financial Statements of Common Interest Realty Associations* (014871, $6)	Compilations and reviews of financial statements for periods ending on or after December 15, 1993

SEC Staff Accounting Bulletins

To order copies, call the SEC Public Reference Branch at (202) 272-7450.

Description		Effective Date
SAB No. 92, Topic 5-Y (June 8, 1993)	*Accounting and Disclosures Relating to Loss Contingencies*	Upon Issuance
SAB No. 93, Topic 5-Z (November 4, 1993)	*Accounting and Disclosures Regarding Discontinued Operations*	Upon Issuance

AICPA Services

.158 *Technical Hotline.* The AICPA Technical Information Service answers inquiries about specific audit or accounting problems. Call toll-free (800) TO-AICPA.

.159 *Ethics Division.* The AICPA's Professional Ethics Division answers inquiries about the application of the AICPA Code of Professional Conduct. Auditors may call any of the following numbers:

(201) 938-3177

(201) 938-3181

(201) 938-3186

* * * *

.160 This audit risk alert replaces *Audit Risk Alert—1992.*

AAM Section 8015

Compilation and Review Alert—1993

NOTICE TO READERS

This compilation and review alert is intended to provide CPAs with an overview of recent practice developments and professional and accounting standards that may affect the compilations and reviews they perform. This document has been prepared by the AICPA staff. It has not been approved, disapproved, or otherwise acted upon by a senior technical committee of the AICPA.

Introduction

.01 The Compilation and Review Alert—1993 is a nonauthoritative practice aid designed to help accountants plan their 1994 compilation and review engagements. It clarifies certain existing professional standards, suggests ways of implementing Statements on Standards for Accounting and Review Services in unusual circumstances, points out pitfalls that frequently occur in compilation and review engagements, and summarizes new professional and accounting pronouncements.

Implementing Statement on Standards for Accounting and Review Services No. 7

.02 Statement on Standards for Accounting and Review Services (SSARS) No. 7, *Omnibus Statement on Standards for Accounting and Review Services—1992*, is effective for periods ending after December 15, 1993. Practitioners who have not early applied SSARS No. 7 will need to revise their compilation and review reports to reflect the new wording established in SSARS No. 7. This omnibus standard amends various sections of SSARS. Some provisions of the standard clarify existing guidance, while others change compilation and review practice.

.03 Major provisions that change compilation and review practice—

- Revise the wording of the SSARS compilation and review reports to clarify that the standards referred to in these reports are Statements on Standards for Accounting and Review Services. This clarification is intended to differentiate the SSARS review report from the review report presented in Statement on Auditing Standards (SAS) No. 71, *Interim Financial Information* (AU section 722). The requirements for a SAS No. 71 (AU section 722) review are more extensive than the requirements for a SSARS review, and the similarity between the two reports could cause financial statement users to assume that the requirements of a SAS No. 71 (AU section 722) engagement have been fulfilled when, in fact, they have not. The Accounting and Review Services Committee (ARSC) decided to revise the wording of the compilation report at the same time they were revising the wording of the SSARS review report. The first paragraphs of the new compilation and review reports are shown below. New language is shown in boldface italics, and deleted language is shown in brackets.

Standard Compilation Report

I (We) have compiled the accompanying balance sheet of XYZ Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with [standards] ***Statements on Standards for Accounting and Review Services*** [established] ***issued*** by the American Institute of Certified Public Accountants.

(*No change to the second paragraph*)

Standard Review Report

I (We) have reviewed the accompanying balance sheet of XYZ Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with [standards] ***Statements on Standards for Accounting and Review Services*** [established] ***issued*** by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation (owners) of XYZ Company.

(*No change to the second and third paragraphs*)

- Make obtaining a representation letter a required, rather than an optional, procedure in a review engagement. To familiarize clients with the purpose and contents of a representation letter, the Auditing Standards Division has prepared a pamphlet titled *The Representation Letter in a SSARS Review Engagement*. The pamphlet is intended for clients who are unfamiliar with a representation letter and who may not have been asked to sign one before. A copy of the pamphlet is included as an attachment to this document [paragraph .89] (Product No. 055120CR; $15 for 25 copies). Pamphlets may be ordered from the AICPA Order Department. (See ordering information in paragraph .88.)

- Exempt a practitioner who types or reproduces client-prepared financial statements, without modification, from having to report on those statements as compiled. Now, SSARS No. 1, *Compilation and Review of Financial Statements* (AR section 100), includes a definition of *submission of financial statements* that was previously included in an interpretation of SSARS. Accountants have had difficulty determining whether the services they perform constitute a submission of financial statements. Paragraph 1 of SSARS No. 1 (AR section 100.01) states that an accountant should not submit a nonpublic entity's unaudited financial statements to a client or others unless he or she complies with SSARS No. 1 (AR section 100). Without a definition of submission, accountants may inadvertently submit financial statements without adhering to professional standards. As amended, SSARS No. 1 (AR section 100) defines submission of financial statements as presenting to a client or others financial statements that the accountant has—

  a. Generated, either manually or through the use of computer software, or

  b. Modified by materially changing account classification, amounts, or disclosures directly on client-prepared financial statements.

.04 Many accountants issue compilation reports for services that do not result in a submission of financial statements. For that reason, SSARS No. 1 (AR section 100) now provides the following examples of services that do not constitute a submission of financial statements:

— Reading client-prepared financial statements

— Typing or reproducing client-prepared financial statements, without modification, as an accommodation to a client (For more information on this topic, see "Typing Client-Prepared Financial Statements" in paragraph .06.)

— Proposing correcting journal entries or disclosures to the financial statements, either orally or in written form, that materially change client-prepared financial statements, as long as the accountant does not directly modify the client-prepared financial statements

— Preparing standard monthly journal entries (for example, standard entries for depreciation and expiration of prepaid expenses)

— Providing a client with a financial statement format that does not include dollar amounts, to be used by the client to prepare financial statements

— Advising a client about the selection or use of computer software that the client will use to generate financial statements

— Providing the client with the use of or access to computer hardware or software that the client will use to generate financial statements

Some practitioners believe that the SSARS definition of submission is too specific. For example, consider the situation in which a client asks an accountant to read client-prepared financial statements, and the accountant identifies the need for a material adjustment. The accountant who marks the effects of a material correcting journal entry or writes a needed disclosure on client-prepared financial statements must adhere to SSARS No. 1 (AR section 100); the accountant who prepares the material adjustment in journal entry format and submits it to the client to record is exempt. In the context of computer-generated financial statements, it actually comes down to who pushes the button that causes the financial statements to be printed. The definition is structured to allow an accountant who performs all services, including input of adjusting entries, to avoid the requirements of SSARS by having the client push the computer print button that generates the financial statements. Although the definition would allow such actions, accountants should not perform services that bring them so close to the boundary of submitting financial statements. Such unprofessional practices do not reflect the spirit of the definition. On the surface it would appear that the ARSC has drawn the boundary so narrowly that it has eliminated the need for judgment when evaluating the submission question. Although some may hold that view, the ARSC believes the only effective way to provide practical and clear guidance is to be specific. Such guidance, however, does not dispense with the accountant's need to exercise judgment.

.05 Major provisions of SSARS No. 7 that clarify existing practice include amendments that—

- Indicate that the definition of generally accepted accounting principles (GAAP) and the hierarchy of established accounting principles presented in SAS No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report* (AU section 411), is also applicable to compilations and reviews of financial statements performed under SSARS.

- Make explicit that the accountant is not required to communicate to a client errors that are not material, and irregularities or illegal acts that are clearly inconsequential.

- Clarify the accountant's reporting responsibilities in a compilation or review engagement when he or she decides there is an uncertainty about an entity's ability to continue as a going concern.

- Indicate that the guidance for evaluating the adequacy of disclosure of going-concern uncertainties is found in paragraphs 10 and 11 of SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU section 341.10 and .11).

- Indicate that the source of guidance for evaluating the adequacy of disclosure in financial statements prepared in conformity with an other comprehensive basis of accounting is paragraphs 9 and 10 of SAS No. 62, *Special Reports* (AU section 623.09 and .10).

- Clarify the applicability of SSARS No. 1 (AR section 100) by indicating that in certain circumstances, an accountant may perform a review of a public company's financial statements under the provisions of SSARS.

- Inform readers of the sources of guidance on preparing and reporting on financial forecasts, projections, and similar presentations.

Typing Client-Prepared Financial Statements

.06 Paragraph 7 of SSARS No. 1 (AR section 100.07) includes a list of services that do not constitute a submission of financial statements. One of the listed services is, "Typing or reproducing client-prepared financial statements, without modification, as an accommodation to a client." Practitioners have asked whether this exemption is applicable when a CPA types client-prepared financial statements on the CPA's letterhead. The Auditing Standards Division recommends that CPAs avoid typing client-prepared financial statements on their letterhead; however, if such a service is performed, the CPA should compile the financial statements and report on them accordingly. The basis for this conclusion is found in paragraph 6 of SSARS No. 1 (AR section 100.06), which states that an accountant should not consent to the use of his or her name in a document or written communication containing unaudited financial statements of a non-public entity unless he or she has compiled or reviewed the financial statements, and his or her report accompanies them.

Tailoring the Illustrative Representation Letter

.07 Now that a representation letter is required in a SSARS review engagement, the Auditing Standards Division is reminding practitioners of the need to tailor each representation letter to fit individual client circumstances. The representation letter included in appendix D of SSARS No. 1 (AR section 100.55) is presented for illustrative purposes only and may need to be modified depending on the circumstances of the review engagement.

.08 For example, the illustrative representation letter in appendix D (AR section 100.55) contains the following client representation:

> The company has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged.

.09 If a client has liens or encumbrances on an asset and they have been properly disclosed in the financial statements, the representation letter should be modified as follows; new language is shown in boldface italics:

> The company has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged, ***other than that which has been properly disclosed in the financial statements.***

.10 Some practitioners believe that the representation letter in a review engagement should be modified to include a representation about management's responsibility for the fair presentation of the financial statements. Paragraph 4 of SAS No. 19, *Client Representations* (AU section 333.04), states that a representation letter in an audit engagement ordinarily includes a representation covering the following matter:

> Management's acknowledgement of its responsibility for the fair presentation in the financial statements of financial position, results of operations, and cash flows in conformity with generally accepted accounting principles or other comprehensive basis of accounting.

Such a representation would also be appropriate for a representation letter in a SSARS review engagement.

.11 Many of the AICPA Audit and Accounting Guides contain recommendations for additional matters that should be covered in the representation letters of entities operating in specific industries. A number of examples follow.

.12 The AICPA Audit and Accounting Guide *Construction Contractors* recommends that accountants consider obtaining representations from management of a construction contractor about the following matters:

- Method of income recognition used
- Provisions for losses on contracts
- Unapproved change orders, claims, and contract postponements or cancellations

- Backlog information, if presented in the financial statements
- Joint venture participations and other related-party transactions

.13 The AICPA Audit and Accounting Guide *Common Interest Realty Associations* (CIRAs) recommends that the accountant consider obtaining representations about the following matters in a CIRA engagement:

- Disclosures based on a study of future major repairs and replacements
- The CIRA's policy for funding future major repairs and replacements
- The CIRA's policy for disposing of the excess of revenues over expenses, if any

.14 AICPA Audit and Accounting Guides summarize the practices applicable to specific industries and describe relevant matters, conditions, and procedures unique to these industries. For a listing of industries for which guides are available, see paragraph .64.

Financial Statements Submitted Electronically

.15 Regulatory bodies or other users of financial statements may request that financial statements be submitted on a computer disk or through a data transmission network. Practitioners have asked about the applicability of SSARS to financial statements submitted in electronic format and about the mechanics of issuing a report when such media are used.

.16 SSARS is applicable to financial statements submitted on a computer disk or through a data transmission network; therefore, an accountant must at least report on such financial statements as compiled. The accountant's compilation report may be included on the disk or transmitted electronically through the data transmission network. There is no requirement that the accountant's report be manually signed and, therefore, no necessity for the accountant to submit a hard copy of the financial statements and accountant's report in these circumstances.

.17 In certain cases, the requesting party may require that the financial statements be submitted on a prescribed form using an electronic format. SSARS No. 3, *Compilation Reports on Financial Statements Included in Certain Prescribed Forms* (AR section 300), defines a prescribed form as a standard preprinted form designed or adopted by the body to which it is to be submitted, for example, forms used by industry trade associations, credit agencies, banks, and governmental and regulatory bodies. A prescribed form calls for departures from GAAP by specifying a measurement principle not in conformity with GAAP or by failing to request the disclosures required by GAAP. The Auditing Standards Division believes that the SSARS No. 3 (AR section 300) definition of a prescribed form also encompasses a prescribed form in electronic format. When the prescribed form is in electronic format, and the form is designed without any means for the accountant to include his or her compilation report on the financial statements, the CPA should separately submit a hard copy of the financial statements and compilation report to the requesting entity.

Performing a Lower Level of Service

.18 Practitioners frequently ask whether they may accept an engagement to perform a lower level of service on financial statements they have previously audited or reviewed, or whether they may compile financial statements that omit substantially all disclosures after having compiled, reviewed, or audited full-disclosure financial statements. This situation is to be differentiated from a step-down request that involves changing the level of service while the engagement is in process.

.19 Paragraph 5 of SSARS No. 1 (AR section 100.05) states that an accountant who performs more than one service on the same set of financial statements (for example, a compilation and an audit), should issue a report on the highest level of service rendered.

.20 Interpretation No. 3 of SSARS No. 1, "Reporting on the Highest Level of Service" (AR section 9100.06–.12), further clarifies this guidance by stating that—

- An accountant who performs more than one service on the same set of financial statements (for example, a compilation and an audit) will not be required to issue a compilation and an audit report. The accountant need only issue the report on the highest level of service performed (the audit report).
- An accountant may accept an engagement to perform a higher level of service on financial statements that he or she previously compiled or reviewed.

SSARS provides fairly clear guidance on matters related to performing a *higher* level of service, but is less clear on the question of whether an accountant may perform a *lower* level of service.

.21 Some practitioners are reluctant to compile financial statements they have previously audited or reviewed because the accountant's compilation report will read, "I have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them." They conclude that the disclaimer in the report would be misleading to financial statement users because the accountant has, in fact, audited or reviewed the financial statements. These practitioners believe that the aforementioned disclaimer precludes the accountant from compiling financial statements after auditing or reviewing them. The Auditing Standards Division interprets the disclaimer in the compilation report to be engagement-specific and, therefore, concludes that the disclaimer refers only to the financial statements that accompany the accountant's report.

.22 Practically, this matter should only present a problem when the accountant is asked to compile financial statements that omit substantially all disclosures after compiling, reviewing, or auditing full-disclosure financial statements, because the financial statements in any other set of circumstances would contain the same information. Such a request might arise, for example, when a client wishes to provide its vendors with compiled financial statements that omit substantially all disclosures.

.23 Paragraph 19 of SSARS No. 1 (AR section 100.19) provides indirect guidance on this matter. It states that an accountant may compile financial statements that omit substantially all disclosures provided the omission of the disclosures is indicated in the report and is not, to the accountant's knowledge, undertaken with the intention of misleading those who might reasonably be expected to use the financial statements. If the accountant believes that the client's intent is to mislead users, the accountant should not comply with the request. However, if the accountant concludes that it is not the client's intent to mislead users, it would be appropriate to compile financial statements with substantially all disclosures omitted after having compiled, reviewed, or audited full-disclosure financial statements.

.24 Additional guidance is found in a footnote to paragraph 5 of SSARS No. 1 (AR section 100.05) indicating that an accountant who previously has reviewed financial statements may subsequently issue a compilation report on financial statements for the same period if they are included in a prescribed form that calls for departure from GAAP.

Correcting Errors in Previously Compiled Financial Statements

.25 A CPA may be asked to audit or review financial statements that he or she previously compiled. In the course of performing the audit or review, the accountant may become aware of misstatements or omissions in the previously compiled financial statements. What are the accountant's responsibilities when such matters come to his or her attention?

.26 Paragraph 42 (AR section 100.42) and Interpretation No. 4 of SSARS No. 1 (AR section 9100.13—.15) refer the accountant to SAS No. 1, section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* (AU section 561), for guidance on such matters with the caveat that the accountant consider the different objectives of compilation, review, and audit engagements in applying the guidance. This section describes the procedures the auditor should follow when, subsequent to the date of the report on the audited financial statements, the auditor becomes aware that facts may have existed at the date of the financial statements that might have affected the auditor's report had he or she been aware of them.

.27 If the nature and effect of the misstatement or omission is such that the accountant's compilation report would have been affected if he or she had been aware of the error in the financial statements at the date of the report, and the accountant believes that there are persons currently relying on or likely to rely on the financial statements, who would attach importance to the information, the accountant should take action to prevent future reliance on the report. Such action would consist of advising the client to disclose the newly discovered information and its effect on the financial statements to users of the compiled financial statements. Disclosure would ordinarily be achieved by—

- Notifying users of the financial statements that revised statements will be issued upon completion of the review or audit. This would be appropriate when issuance of revised financial statements will be delayed because of the need for prolonged investigation of the matter.
- Issuing revised financial statements and a revised report. If the financial statements have been audited or reviewed, the reason for the revision usually should be described in a note to the financial statements. If the financial statements have been audited, the reason for the revision should be referred to in the auditor's report. If the financial statements have been reviewed, the accountant may add a paragraph to the report describing the reason for the revision; however, this is not required if the reason for the revision is adequately disclosed in the financial statements.

.28 The literature does not provide specific guidance on how to ensure that all clients will be notified about the misstated financial statements. A practical solution is for the client to request that users return all misstated financial statements and reports. The accountant might also request that the client represent, in writing, that all users have been notified of the matter and will be provided with copies of the revised financial statements and report.

.29 In any situation where misstated financial statements are accompanied by an unmodified accountant's report, the accountant should consider consulting his or her attorney.

Creative Report Language

.30 The sample compilation and review reports presented in SSARS are illustrative rather than authoritative. A practitioner's report does not have to read exactly like the sample reports in SSARS; however, a compilation or review report that does not include the elements listed in paragraphs 14 and 32, respectively, of SSARS No. 1 (AR section 100.14 and .32) would be considered deficient.

.31 Paragraph 14 (AR section 100.14) establishes the requirements for a report on compiled financial statements:

> Financial statements compiled without audit or review by an accountant should be accompanied by a report stating that—
>
> *a.* A compilation has been performed in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.
>
> *b.* A compilation is limited to presenting in the form of financial statements information that is the representation of management (owners).
>
> *c.* The financial statements have not been audited or reviewed and, accordingly, the accountant does not express an opinion or any other form of assurance on them.

.32 Paragraph 32 (AR section 100.32) establishes the requirements for a report on reviewed financial statements.

> Financial statements reviewed by an accountant should be accompanied by a report stating that—

a. A review was performed in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

b. All information included in the financial statements is the representation of the management (owners) of the entity.

c. A review consists principally of inquiries of company personnel and analytical procedures applied to financial data.

d. A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements taken as a whole and, accordingly, no such opinion is expressed.

e. The accountant is not aware of any material modifications that should be made to the financial statements in order for them to be in conformity with generally accepted accounting principles, other than those modifications, if any, indicated in his report.

Although a practitioner does have some latitude in how these elements are expressed, the courts have demonstrated a preference for the standard compilation and review reports and deviating from the standard reports may elevate a firm's malpractice risk. The Auditing Standards Division recommends that firms use the standard report formats presented in SSARS.

Engagement Letters

.33 Paragraph 8 of SSARS No. 1 (AR section 100.08) states that the accountant should establish an understanding with the entity, preferably in writing, regarding the services to be performed. Although an engagement letter is not required under SSARS, the Auditing Standards Division recommends that practitioners prepare an engagement letter for all engagements.

.34 In today's litigious environment, liability claims against a CPA firm are always a concern. An engagement letter may help to minimize liability by documenting the details of the agreement between the CPA and the client. A well-written engagement letter helps to prevent misunderstanding, acts as a memory jogger when misunderstanding does occur, and reduces unrealistic expectations about the service to be performed.

.35 An engagement letter ordinarily should include the following elements:

- A description of the nature of the service to be performed and the limitations of the service
- A description of any additional services to be performed such as tax-return preparation or bookkeeping services
- An indication of the time period covered by the engagement
- An example of the report the accountant expects to render
- An indication of the frequency with which the service will be rendered, especially when different services will be rendered with different frequencies
- An indication of the client's responsibilities during the engagement such as responsibility for the preparation of account analyses
- Fees for the service and billing arrangements
- A statement that the engagement cannot be relied on to disclose errors, irregularities, or illegal acts
- A statement that the accountant will inform the appropriate level of management of any material errors that come to his or her attention and any irregularities or illegal acts that come to his or her attention, unless they are clearly inconsequential

Practitioners will need to revise their engagement letters to reflect changes in the wording of the compilation and review reports, as well as other changes introduced by SSARS No. 7. The illustrative engagement letters presented in appendixes B and C of SSARS No. 1 (AR section 100.53 and .54) have been revised to reflect these changes. (See paragraphs .02-.04 for a summary of the provisions of SSARS No. 7.)

Maintaining Independence When Providing Payroll Services

.36 CPAs may be asked to perform payroll preparation services for compilation or review clients when the employee responsible for payroll is away or when management elects to have this service performed outside the organization. Management may prefer to have the CPA perform this service to preserve confidentiality or because no one on staff is trained to perform this service. A CPA providing payroll services should be aware of the need to maintain independence when performing an engagement that requires independence. The AICPA *Code of Professional Conduct* (ET section 101.05), states that independence is impaired when the accountant assumes the role of management. For this reason, management—not the CPA—should determine which employees will be paid and the amounts they will be paid. Using the information provided by management, the CPA may calculate the payroll, transmit payroll information to a payroll service, record the payroll, and complete payroll tax returns. However, the CPA should not sign payroll checks or payroll tax returns because these are responsibilities of management.

.37 Before an accountant may report on financial statements, the client must accept responsibility for the financial statements as his or her own. This means that the client must be sufficiently informed of the enterprise's activities, financial condition, and the accounting principles used to record transactions. Payroll transactions become part of the financial statements. If management is not sufficiently informed about payroll transactions, the CPA should discuss payroll accounting matters with the client.

.38 The CPA is precluded from issuing an audit or review report on the financial statements of an entity with respect to which he or she is not independent, but may compile such financial statements. If the accountant is not independent in a compilation engagement, the following paragraph should be added to the compilation report:

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

Responsibility for Determining the Appropriateness of an Engagement

.39 Certain entities may be required by law, regulation, or contractual agreement to submit reviewed or audited financial statements. Management, not the CPA, is responsible for determining the level of service required and for engaging a CPA to perform that service. However, if a CPA becomes aware that the planned level of service does not meet relevant legal, regulatory, or contractual requirements, the CPA should inform the client of that fact. Although not required, the Auditing Standards Division recommends that any communication about this matter be in writing. If the communication is oral, the Auditing Standards Division recommends that it be documented in the engagement working papers.

.40 The decision as to the type of engagement that will be performed should be an informed decision. Clients need to understand the difference between a compilation, review, and audit engagement and should be aware of the different levels of assurance provided in each engagement. The CPA should inform the client of the differences between the engagements and their relative values to the client. The Auditing Standards Division has prepared a pamphlet titled *Understanding Compilation, Review and Audit* that is designed to educate clients about the different types of services a CPA may provide. A copy of this pamphlet is included as an attachment [paragraph .90] to this document (Product No. 338567CR; $22 per 100 copies). Pamphlets may be ordered from the AICPA Order Department. (See ordering information in paragraph .88.)

Disclosure and Reporting Requirements When Financial Statements are Prepared in Accordance With an Other Comprehensive Basis of Accounting

.41 It is important that the users of financial statements be aware of and understand the basis of accounting used when financial statements are prepared on a comprehensive basis of accounting other than GAAP. Examples of other comprehensive bases of accounting are the tax basis and the cash basis.

.42 Footnote 4 of SSARS No. 1 (AR section 100.04, footnote 4) refers the accountant to paragraphs 9 and 10 of SAS No. 62 (AU section 623.09 and .10) for guidance on evaluating the adequacy of disclosure in financial statements prepared in conformity with an other comprehensive basis of accounting (OCBOA). Paragraph 10 of SAS No. 62 (AU section 623.10) states that such financial statements should include a note discussing the basis of presentation and describing how that basis differs from GAAP. The effects of the differences between GAAP and the basis of accounting used in the financial statements need not be quantified. An example of a financial statement note describing the cash basis of accounting and how it differs from GAAP follows:

> *Note 1—Cash Basis of Accounting*
>
> The Company prepares its financial statements on the cash basis of accounting but records depreciation and amortization of capitalized assets; liabilities for payroll withholdings; and accruals for payroll taxes, profit sharing contributions, and income taxes payable. Under the cash basis of accounting, revenues are recognized when collected rather than when earned, and expenses are generally recognized when paid rather than when incurred. Consequently accounts receivable from customers, trade accounts payable, and accrued expenses, other than those mentioned above, are not included in the financial statements as of December 31, 19XX.

Paragraph 7 of SAS No. 62 (AU section 623.07) describes suitable titles for OCBOA financial statements. Because these financial statements do not present financial position and results of operations in accordance with GAAP, they should not be captioned or referred to using unmodified GAAP titles such as "Balance Sheet" or "Income Statement." Examples of appropriate titles for cash basis financial statements include "Statement of Assets and Liabilities Arising from Cash Transactions" and "Statement of Revenue Collected and Expenses Paid."

.43 When financial statements contain adequate note disclosure concerning the basis of presentation, and the financial statements are appropriately titled, a standard compilation or review report may be issued using the OCBOA financial statement titles. When the basis of accounting is not disclosed in the financial statements, the compilation or review report should be modified.

.44 Paragraph 20 (AR section 100.20) and Interpretation No. 12 of SSARS No. 1 (AR section 9100.41—.45) indicate that OCBOA financial statements that omit substantially all disclosures should disclose the basis of accounting used. When these financial statements do not include disclosure of the basis of accounting, the basis should be disclosed in the accountant's report. This may be accomplished by adding a sentence such as the following to the first paragraph of the accountant's compilation report:

> The financial statements have been prepared on the cash basis of accounting, which is a comprehensive basis of accounting other than generally accepted accounting principles.

Financial Statements Included With the Findings or Recommendations of Management Consulting Services Engagements

.45 A CPA may be engaged to perform management consulting services that result in written findings or recommendations for client consideration and decision making on subjects such as business valuation, purchase/lease decisions, and product pricing. When financial statements are included with the written findings or recommendations of a management consulting services engagement and are submitted to a client or others (as defined in paragraph 7 of SSARS No. 1 [AR section 100.07]), SSARS are applicable and the accountant must at least compile the financial statements.

.46 The fact that the financial statements may only be incidental to the management consulting service engagement does not mitigate the need for the accountant to compile the financial statements. After an accountant submits financial statements to a client or others, he or she has little control over who will use the financial statements or how they will be used. That is why it is imperative that financial statements submitted by the accountant be accompanied by the accountant's report. The report tells the reader what service has been performed on the financial statements and the degree of responsibility the accountant is taking for those financial statements.

.47 If the financial statements included with the findings or recommendations of a management consulting service engagement have not been submitted by the accountant (for example, when they are prepared by the client), the financial statements should be accompanied by an indication that the accountant has not compiled or reviewed the financial statements and assumes no responsibility for them.

.48 The AICPA *Code of Professional Conduct* (ET section 92.04) states that *incidental financial information*, included in management consulting services reports to support recommendations to a client, do not constitute financial statements. The professional standards provide no further clarification of the meaning of incidental financial information; however, if a presentation is deemed to be a financial statement, SSARS is applicable. Paragraph 4 of SSARS No. 1 (AR section 100.04) includes a definition of financial statement and examples of presentations that are considered financial statements. In addition, Interpretation No. 15 of SSARS No. 1 (AR section 9100.54—.57) provides guidance on differentiating a financial statement from a trial balance.

RMA Prescribed-Form Financial Statements

.49 Robert Morris Associates (RMA), the association of bank lending officers, in conjunction with the AICPA Technical Issues Committee of the Private Companies Practice Section, has developed the *Business Credit Information Package* (BCIP), which can be used by nonpublic businesses when applying for credit from financial institutions. The BCIP contains a prescribed form for financial statements that requires selected disclosures rather than full disclosure and is tailored to the information needs of financial institutions.

.50 SSARS No. 3 (AR section 300) provides for an alternative form of compilation report when a prescribed form or related instructions calls for departures from GAAP by specifying a measurement principle not in conformity with GAAP or by failing to request the disclosures required by GAAP. The prescribed form for financial statements included in the BCIP requires all of the measurement disclosures of a GAAP presentation but not all of the note disclosures required by GAAP; therefore, SSARS No. 3 (AR section 300) is applicable to these financial statements.

.51 The BCIP contains the following sections:

- A *Request Letter*—The letter is issued by the banker and indicates the kind of financial information that will be required from the borrower. For prescribed-form financial statements to meet the requirements of SSARS No. 3 (AR section 300), they must be requested by the lender, not the client or the CPA. The banker must accept responsibility for requesting financial statements that omit some of the disclosures required by GAAP. The *Request Letter* documents that the lender has requested the prescribed-form financial statements included in the BCIP.

- A *Business Borrower Questionnaire*—The questionnaire requests information about matters such as the company's major products or services, customers and suppliers, insurance coverage, accounting policies and procedures, and expected and past changes in the company.

- A *Reporting and Disclosure Checklist*—The checklist indicates which financial statements and disclosures are required by the lender.

- A *Prescribed Form for the Preparation of Financial Statements*—The completed form serves as the financial statements and supplementary schedules.

- A *Sample Accountant's Report*—The sample report provides an example of the report the accountant will render on the prescribed-form financial statements and supplementary schedules.

In addition to financial statements, the *Request Letter* lists other information that the borrower may need to submit. Those items include interim financial statements, income tax returns, personal financial statements of the owner(s), copies of loan agreements for all existing credit facilities, and a copy of the current actuarial report for defined benefit plans. If the accountant submits interim financial statements for the entity or personal financial statements for the owner(s) of the entity, the accountant should at least compile the financial statements as required by SSARS No. 1 (AR section 100). (Additional guidance concerning compilation and review of personal financial statements is found in the *AICPA Personal Financial Statements Guide*, Product No. 011133CR; $26.) Preparation of income tax returns is an accounting service that is specifically excluded from SSARS No. 1 (AR section 100), and the submission of copies of loan agreements and actuarial reports by the CPA are services that fall outside the scope of SSARS.

.52 When all of the information requested by the banker is submitted as a package, the CPA should ensure that his or her lack of responsibility for any information he or she has not compiled, reviewed, or audited is clearly communicated.

Considering or Accepting Employment With a Client

.53 The AICPA *Code of Professional Conduct* (ET section 191.154) requires that an individual who is offered employment by, or seeks employment with, a client during the conduct of an engagement consider whether or not his or her ability to act with integrity and objectivity has been impaired. When an engagement, such as a review, requires independence, such individuals should remove themselves from the engagement until the employment offer is rejected or employment is no longer being sought, to prevent any appearance that integrity or objectivity has been impaired.

.54 A CPA may become aware that an individual participated in an engagement while employment with the client was being considered or after it had already been accepted. The CPA should consider what, if any, additional procedures may be necessary to ensure that all work was performed with objectivity and integrity, as required under Rule 102 of the AICPA *Code of Professional Conduct* (ET section 102.01). Any additional procedures will depend on the nature of the engagement and may require reperformance of the work or other appropriate procedures.

.55 If independence is impaired, a review report should not be issued without reperformance of procedures or performance of other procedures. However, a compilation report with a paragraph added, noting the lack of independence, may be issued without performing additional work.

Recurring Reporting Deficiencies Noted in Compilation and Review Engagements

.56 Certain frequently recurring reporting deficiencies are noted in peer and quality review letters of comment on compilation and review engagements. Among these deficiencies are the failure of the accountant's report to—

- Refer to all periods presented.
- Indicate the degree of responsibility assumed by the accountant for supplementary information presented with the financial statements.
- Indicate, when appropriate, that the financial statements are presented in conformity with an other comprehensive basis of accounting.
- Indicate that a statement of cash flows is not presented.
- Identify GAAP departures such as the lack of a tax provision.
- Cite titles that match the titles of the financial statements.

GAAP for Compiled or Reviewed Financial Statements

.57 Although there are different reporting and performance standards for compilation, review, and audit engagements, the accounting principles to be followed in compiled and reviewed financial statements are the same as those in audited financial statements. Recently issued SSARS No. 7 adds a footnote to SSARS No. 1 (AR section 100) to remind practitioners that the definition of GAAP and the hierarchy of established accounting principles presented in SAS No. 69 (AU section 411) are applicable to compilations and reviews of financial statements.

.58 A deficiency frequently noted in quality reviews of compilation and review engagements is the omission of certain financial statement disclosures required by GAAP. To avoid the inadvertent omission of required disclosures, many practitioners use a disclosure checklist that typically consists of a number of brief questions or statements accompanied by references to authoritative pronouncements. Checklists may be firm-generated or purchased from the AICPA or commercial publishers. The AICPA sells a generic corporation checklist and many industry-specific checklists. For additional information about these checklists, consult the *AICPA Catalog of Publications*. A free catalog may be obtained from the AICPA Order Department. (For ordering information see paragraph .88.)

.59 The effective use of a disclosure checklist requires that a practitioner own or have access to certain authoritative accounting pronouncements. SAS No. 69 (AU section 411), issued in January 1992, revised the GAAP hierarchy and elevated the authority of certain accounting pronouncements, including AICPA Audit and Accounting Guides (the Guides), Statements of Position (SOPs), and FASB Emerging Issues Task Force (EITF) Consensus Positions. Because several organizations establish GAAP, there is no single publication that includes all GAAP pronouncements; however, the following publications contain pronouncements included in levels *a* through *d* of the GAAP hierarchy (must-know GAAP) and—if acquired and maintained—should provide accountants with an appropriate accounting library.

FASB Original Pronouncements—Accounting Standards

.60 This two-volume set contains the original text of accounting pronouncements. It includes Financial Accounting Standards Board (FASB) Statements of Financial Accounting Standards and Interpretations, Accounting Principles Board (APB) Opinions, AICPA Accounting Research Bulletins, FASB Technical Bulletins, and AICPA Accounting Interpretations. The pronouncements are arranged chronologically and the text includes a topical index (Product No. 005043CR; $83.50).

AICPA Technical Practice Aids (Including Statements of Position)

.61 SOPs issued by the AICPA Accounting Standards Division and Accounting Standards Executive Committee (AcSEC) Practice Bulletins are included in this text. SAS No. 69 (AU section 411) elevated the status of AcSEC Practice Bulletins to the authority of established accounting principles. This publication also contains a selection of nonauthoritative audit, review, compilation, and accounting questions answered by the AICPA's Technical Information Service (Product No. 005053CR; $60).

FASB Emerging Issues Task Force Abstracts

.62 This text contains a summary of the proceedings of the FASB's EITF. Each abstract summarizes the accounting issues involved and the results of the discussion, including any consensus reached on the issue. SAS No. 69 (AU section 411) elevated the status of EITF consensuses to the authority of established accounting principles. (Available from the FASB, (203) 847-0700, extension 10, Product No. EAB93; $33.)

FASB Staff Qs and As

.63 Qs and As published by the FASB staff provide guidance on the implementation of FASB Statements and are available for Statement Nos. 80, 86, 87, 88, 91, 96, 109, and 113.

AICPA Audit and Accounting Guides

.64 These Guides summarize the practices applicable to specific industries and describe relevant matters, conditions, and procedures unique to these industries. The accounting guidance included in the Guides is in the GAAP hierarchy as authoritative GAAP. When an accountant compiles or reviews the financial statements of an entity, SSARS requires that the accountant possess or acquire a level of knowledge of the accounting principles and practices of the industry in which the entity operates. Although the audit guidance included in the Guides may not be relevant to practitioners performing compilation and review engagements, the accounting guidance, illustrative financial statements and industry background included in the Guides should help accountants acquire knowledge of a specific industry. Guides are available for the following industries (product numbers are shown in parentheses):

Agricultural Producers and Agricultural Cooperatives (012142CR)

Airlines (013178CR)

Banks (011173CR)

Brokers and Dealers in Securities (012176CR)

Casinos (013145CR)

Certain Nonprofit Organizations (013164CR)

Colleges and Universities (013322CR)

Common Interest Realty Associations (CIRAs) (012483CR); this guide contains a chapter on compilations and reviews of CIRAs.

Construction Contractors (012091CR)

Credit Unions (012048CR)

Employee Benefit Plans (012332CR)

Entities With Oil and Gas Producing Activities (012086CR)

Federal Government Contractors (012433CR)

Finance Companies (012461CR)

Investment Companies (012138CR)

Property and Liability Insurance Companies (011916CR)

Providers of Health Care Services (012426CR)

Savings Institutions (012102CR)

State and Local Governmental Units (012053CR)

Stock Life Insurance Companies (012034CR)

Voluntary Health and Welfare Organizations (012157CR)

Copies of Audit and Accounting Guides are printed in this service and are available from the AICPA Order Department; $26 each.

Compilations and Reviews of Governmental Entities

.65 Practitioners who compile or review the financial statements of state and local governmental entities should supplement their professional libraries with the *Codification of Original Pronouncements: Governmental Accounting and Financial Reporting Standards.* This text contains current authoritative accounting and financial reporting standards for state and local governmental entities. Governmental Accounting Standards Board (GASB) Statements, Interpretations, and Technical Bulletins are included. To order call the FASB at (203) 847-0700, ext. 10 (Product No. GCD93; $40).

Accounting Issues and Developments

Losses Resulting From Catastrophic Events

.66 Losses resulting from catastrophic events have reached record proportions and natural disasters continue to cause damage that results in significant financial loss. Judgment is required in determining the appropriate income statement presentation of losses arising from catastrophic events. APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions* (AC I13), establishes the criteria for reporting extraordinary items in the income statement. Only in rare circumstances does an event—even a catastrophic event—meet both the *unusual nature and infrequency of occurrence* criteria of APB Opinion No. 30 (AC I13) for extraordinary item treatment. In most cases, losses stemming from natural catastrophes do not meet the second criterion—infrequency of occurrence. Events such as hurricanes, tropical storms, winter storms, and floods from heavy rains generally are not infrequent, because they are reasonably expected to recur in the foreseeable future in the environment in which the entity operates. Therefore, generally, it is not appropriate to report losses arising from such events as extraordinary items.

Postemployment Benefits

.67 In November 1992, the FASB issued Statement No. 112, *Employers' Accounting for Postemployment Benefits* (AC P32), to establish accounting standards for entities that provide post-employment benefits to former or inactive employees. The Statement is effective for fiscal years beginning after December 15, 1993.

.68 Postemployment benefits include, but are not limited to, salary continuation, supplemental unemployment benefits, severance benefits, disability-related benefits, job training and counseling, and continuation of health care benefits and life insurance coverage. The Statement requires that entities accrue an obligation to provide postemployment benefits if all of the following conditions are met:

- The obligation is attributable to employees' services already rendered.
- Employees' rights to those benefits accumulate or vest.
- Payment of the benefits is probable.
- The amount of the benefits can be reasonably estimated.

If all of the preceding conditions are not met, entities should follow the guidance in FASB Statement No. 5, *Accounting for Contingencies* (AC C59), and accrue postemployment benefits when it is probable that a liability has been incurred and the amount can be reasonably estimated. If an obligation for postemployment benefits is not accrued in accordance with these requirements only because the amount cannot be reasonably estimated, the entity should disclose that fact in the financial statements.

Postretirement Benefits Other Than Pensions

.69 In December 1990, the FASB issued Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions* (AC P40). Although it applies to all forms of postretirement benefits other than pensions, Statement No. 106 (AC P40) principally focuses on postretirement health care benefits. The Statement is effective for fiscal years beginning after December 15, 1992, with a two-year delayed effective date for plans outside the U.S. and certain small nonpublic employers. The FASB has published "A Guide to Implementation of Statement 106 on Employers' Accounting for Postretirement Benefits Other Than Pensions." This publication is available from the FASB (203) 847-0700, extension 10, Product No. PQA106; $11.

Income Taxes

.70 In February 1992, the FASB issued Statement No. 109, *Accounting for Income Taxes* (AC I27), which is effective for fiscal years beginning after December 15, 1992. FASB Statement No. 109 (AC I27) requires an asset and liability approach for financial accounting and reporting for income taxes. It requires recognition of (1) current tax liabilities or assets for the estimated taxes payable or refundable on tax returns for the current year, and (2) deferred tax liabilities or assets for the estimated future tax effects attributable to temporary differences and tax operating loss and credit carryforwards.

.71 Practitioners will need to consider how the enactment of the Omnibus Reconciliation Act of 1993 (the Act), signed into law on August 10, 1993, will affect the valuation allowance for a deferred tax asset and the deferred tax provision. The effect of the Act's change in tax laws and rates on taxes for the current year should be recognized in the period that includes the enactment date (third quarter for calendar year entities). As such, the effect is a component of the income tax provision attributable to continuing operations and should not be presented on the face of the statement of operations in any manner that would imply anything else.

.72 Statement No. 109 (AC I27) requires that deferred tax assets be recognized for temporary differences that will result in deductible amounts in the future and for carryforwards. A deferred tax asset valuation allowance must be established if it is "more likely than not" that all or a portion of the deferred tax assets will not be realized. The judgment about the need for a valuation allowance depends on each entity's specific facts and circumstances; there are no precise formulas for determining whether a valuation allowance is needed or the amount of the allowance. Such need is based on an assessment of the likelihood of the entity's ability to generate sufficient taxable income of the appropriate character (for example, ordinary income or capital gain) within the carryback or carryforward period under the applicable tax law to realize the tax benefits recognized as a result of deductible temporary differences, operating loss carryforwards, and tax credit carryforwards. The FASB has issued "A Guide to Implementation of Statement 109 on Accounting for Income Taxes." The publication is available from the FASB, (203) 847-0700, extension 10, Product No. TQA109, $11.

.73 The EITF has addressed several issues related to income taxes. Reference should be made to EITF Consensus Positions in the "Other Pronouncements" section in paragraph .85.

Impairment of Loans

.74 In May 1993, FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan* (AC I08), was issued. This Statement applies to financial statements for fiscal years beginning after December 15, 1994. Earlier application is encouraged. The Statement *is applicable to all creditors, not just financial institutions,* and to all loans, uncollateralized as well as collateralized. Large groups of smaller-balance homogeneous loans collectively evaluated for impairment and loans measured at fair value or at the lower of cost or fair value, in accordance with specialized industry practices, are among the exceptions to this Statement.

.75 The Statement amends FASB Statement No. 5 (AC C59) to clarify that a creditor should evaluate the collectibility of both contractual interest and contractual principal of all receivables when assessing the need for a loss accrual. The Statement also amends FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings* (AC D22), to require that a creditor measure all loans restructured in a troubled debt restructuring involving a modification of terms in accordance with its provisions.

.76 A loan, according to FASB Statement No. 114 (AC I08), is a contractual right to receive money on demand or on fixed or determinable dates that is recognized as an asset in the creditor's statement of financial position. Examples include, but are not limited to, accounts receivable (with terms exceeding one year) and notes receivable. A loan is impaired when it is probable that a creditor will be unable to collect all amounts due (including both the contractual interest payments and the principal payments) according to the terms of the loan agreement. Statement No. 114 (AC I08) requires that impaired loans within its scope be measured on the basis of the present value of expected future cash flows discounted at the loan's effective interest rate or as a practical expedient, at the loan's observable market price or the fair value of collateral if the loan is collateral dependent.

.77 The term *probable* used in Statement No. 114 (AC I08) is consistent with its use in FASB Statement No. 5 (AC C59) and means that the future event or events are likely to occur. Paragraph 84 of Statement No. 5 (AC C59.105, footnote 2) notes that the conditions for accrual established in Statement No. 5 (AC C59) are not inconsistent with the accounting concept of conservatism. That is, the conditions established in Statement No. 5 (AC C59) are not intended to be so rigid that they require virtual certainty before a loss is accrued. They require only that it be *probable* that an asset has been impaired or a liability has been incurred and that the amount of loss be *reasonably* estimable.

Investments in Securities

.78 In May 1993, the FASB issued Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (AC I80), which is effective for fiscal years beginning after December 15, 1993. The new Statement supersedes FASB Statement No. 12, *Accounting for Certain Marketable Securities* (AC I89), and its related interpretations. *Statement No. 115 will affect almost all business enterprises.* The greatest effect, however, is expected to be on financial entities. The Statement covers all debt securities as well as the marketable equity securities that have readily determinable fair values. Not covered are securities accounted for by the equity method and investments in consolidated subsidiaries. This Statement does not apply to not-for-profit organizations and certain other entities that already report substantially all debt and equity securities at fair values.

.79 Statement No. 115 (AC I80) establishes the following three categories for investments covered by the Statement and also provides the following reporting guidance for each category:

- *Held-to-maturity securities* (debt securities that the entity has the positive intent and ability to hold to maturity), to be reported at amortized cost
- *Trading securities* (debt and equity securities that are bought and held principally for the purpose of selling them in the near future), to be reported at fair value, with unrealized gains and losses included in earnings
- *Available-for-sale securities* (debt and equity securities not classified as either held-to-maturity or trading), to be reported at fair value, with unrealized gains and losses excluded from earnings and reported in a separate component of equity until realized

An entity should not classify a debt security as held-to-maturity if the enterprise has the intent to hold the security for only an indefinite period. Consequently, a debt security should not, for example, be classified as held-to-maturity if the enterprise anticipates that the security would be available for sale in response to changes in market interest rates and related changes in the security's prepayment risk, needs for liquidity, changes in the availability of and the yield on alternative investments, changes in funding sources and terms, or changes in foreign currency risk.

.80 Paragraph 8 of the Statement (AC I89.105) indicates that certain changes in circumstances may cause the enterprise to change its intent to hold a certain security to maturity without calling into question its intent to hold other debt securities to maturity in the future. Such circumstances include evidence of a significant deterioration in the issuer's credit-worthiness or a change in tax law that eliminates or reduces the tax-exempt status of interest on the debt security. In addition, other events that are isolated, nonrecurring, and unusual for the reporting enterprise that could not have been reasonably anticipated may cause an entity to sell or transfer a held-to-maturity security without necessarily calling into question its intent to hold other debt securities to maturity. Such sales and transfers of held-to-maturity securities are expected to be rare.

.81 In discussing the impairment of securities other than trading securities, Statement No. 115 (AC I89) indicates that if the decline in an individual security's fair value is judged to be other than temporary, its cost basis must be written down to fair value, which becomes the new cost basis. The amount of the write-down is included in earnings. For example, an other-than-temporary impairment exists if it is probable that the investor will be unable to collect all amounts due (principal and interest), according to the contractual terms of a debt security not impaired at acquisition.

.82 The Statement specifically prohibits retroactive restatement of prior years' financial statements. Although Statement No. 115 (AC I89) typically would be initially applied as of the beginning of a fiscal year (such as January 1, 1994), entities are permitted to initially apply the Statement as of the end of an earlier annual period for which financial statements have not yet been issued (with no restatement of interim periods).

.83 Since all entities with a calendar fiscal year must classify their investments in securities in accordance with Statement No. 115 (AC I89) as of January 1, 1994, those entities will also be able to apply the Statement as of December 31, 1993, if they wish to do so in their 1993 annual financial statements.

Contributions Received and Made

.84 In June 1993, the FASB issued Statement No. 116, *Accounting for Contributions Received and Contributions Made* (AC C67). The Statement is effective for financial statements issued for fiscal years beginning after December 15, 1994, with earlier application encouraged. Statement No. 116 (AC C67) establishes accounting standards for contributions and *applies to all entities that receive or make contributions.* With issuance of this Statement, the FASB has specified when and on what basis contributions should be recognized by both contributors and recipients. The Statement defines a contribution (avoiding the term *pledge*) as "an unconditional transfer of cash or other assets...or a settlement or cancellation of its liabilities in a voluntary nonreciprocal transfer...." Generally, contributions received, including unconditional promises to give, are recognized as revenues in the period received at their fair values. Contributions made, including unconditional promises to give, are recognized as expenses in the period made at their fair values. Conditional promises to give, whether received or made, are recognized when they become unconditional, that is, when the conditions are substantially met.

Other Pronouncements

.85 Following is a list of various authoritative pronouncements issued from January 1, 1993, to November 30, 1993, and their effective dates.

Statements of Financial Accounting Standards and Interpretations Issued by the FASB

To order copies, call the FASB at (203) 847-0700, ext. 10.

Description		Effective Date
FASB No. 114 (May 1993)	*Accounting by Creditors for Impairment of a Loan* (AC I08)	Financial statements for fiscal years beginning after December 15, 1994
FASB No. 115 (May 1993)	*Accounting for Certain Investments in Debt and Equity Securities* (AC I80)	Fiscal years beginning after December 15, 1993 (to be initially applied as of the beginning of an enterprise's fiscal year and may not be applied retroactively)
FASB No. 116 (June 1993)	*Accounting for Contributions Received and Contributions Made* (AC C67)	Financial statements issued for fiscal years beginning after December 15, 1994, except for not-for-profit organizations with less than $5 million in total assets and less than $1 million in annual expenses (for those organizations, the Statement is effective for fiscal years beginning after December 15, 1995)
FASB No. 117 (June 1993)	*Financial Statements of Not-for-Profit Organizations* (AC N05)	Annual financial statements issued for fiscal years beginning after December 15, 1994, except for organizations with less than $5 million in total assets and less than $1 million in annual expenses (for those organizations, the Statement is effective for fiscal years beginning after December 15, 1995)
Interpretation No. 40 (April 1993)	*Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises* (AC In6)	Financial statements issued for fiscal years beginning after December 15, 1994, except for the disclosure provisions, which are effective for fiscal years beginning after December 15, 1992

EITF Consensus Positions

To order copies, call the FASB at (203) 847-0700, ext. 10.

	Description	Date Position Reached
92-12	*Accounting for OPEB Costs by Rate-Regulated Enterprises*	January 21, 1993
93-1	*Accounting for Individual Credit Card Acquisitions*	May 20, 1993
93-2 *	*Effect of Acquisition of Employer Shares for/by an Employee Benefit Trust on Accounting for Business Combinations*	January 21, 1993
93-3	*Plan Assets Under FASB Statement No. 106*	January 21, 1993
93-4	*Accounting for Regulatory Assets*	March 16, 1993
93-5	*Accounting for Environmental Liabilities*	May 20, 1993
93-6	*Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding- and Assuming Enterprises*	July 22, 1993
93-7	*Uncertainties Related to Income Taxes in a Purchase Business Combination*	March 16, 1993
93-8	*Accounting for the Sale and Leaseback of an Asset That Is Leased to Another Party*	July 22, 1993
93-9	*Application of FASB Statement No. 109 in Foreign Financial Statements Restated for General Price-Level Changes*	September 23, 1993
93-10*	*Accounting for Dual Currency Bonds*	September 23, 1993
93-11	*Accounting for Barter Transactions Involving Barter Credits*	November 18, 1993
93-12	*Recognition and Measurement of the Tax Benefit of Excess Tax-Deductible Goodwill Resulting from a Retroactive Change in Tax Law*	September 23, 1993
93-13	*Effect of a Retroactive Change in Enacted Tax Rates That Is Included in Income from Continuing Operations*	September 23, 1993
93-14	*Accounting for Multiple-Year Retrospectively Rated Insurance Contracts by Insurance Enterprises and Other Enterprises*	November 18, 1993
93-16	*Application of FASB Statement No. 109 to Basis Differences Within Foreign Subsidiaries That Meet the Indefinite Reversal Criterion of APB Opinion No. 23*	November 18, 1993

* Because of the SEC staff's position on this matter, the EITF did not reach a consensus on the issue.

Statements of Position Issued by the AICPA

To order copies, call the AICPA at (800) TO-AICPA. Product numbers and prices are shown in parentheses.

	Description	*Effective Date*
SOP No. 93-1 (January 28, 1993)	*Financial Accounting and Reporting for High-Yield Debt Securities by Investment Companies* (014876CR, $6)	Financial statements and for audits of such financial statements for fiscal years ending after December 15, 1993, and for interim periods within such years
SOP No. 93-2 (February 1, 1993)	*Determination, Disclosure, and Financial Statement Presentation of Income, Capital Gain, and Return of Capital Distributions by Investment Companies* (014877CR, $6)	Annual financial statements for fiscal years ending after December 15, 1993, and for interim statements for periods in such years
SOP No. 93-3 (March 19, 1993)	*Rescission of Accounting Principles Board Statements* (014878CR, $6)	Upon Issuance
SOP No. 93-4 (April 22, 1993)	*Foreign Currency Accounting and Financial Statement Presentation for Investment Companies* (014874CR, $6)	Financial statements for fiscal years beginning after December 15, 1993, and interim periods within such years
SOP No. 93-5 (April 23, 1993)	*Reporting on Required Supplementary Information Accompanying Compiled or Reviewed Financial Statements of Common Interest Realty Associations* (014871CR, $6)	Compilations and reviews of financial statements for periods ending on or after December 15, 1993
SOP No. 93-6 (November 22, 1993)	*Employers' Accounting for Employee Stock Ownership Plans* (014803CR, $6)	Fiscal years beginning after December 15, 1993; refer to the SOP for certain transition provisions

Note: The AICPA plans to issue the following two SOPs in December 1993:

	Description	*Effective Date*
SOP No. 93-7 (December 29, 1993)	*Reporting on Advertising Costs* (014804CR, $6)	Financial statements for fiscal years beginning after June 15, 1994
SOP No. 93-8 (December 29, 1993)	*The Auditor's Consideration of Regulatory Risk-Based Capital for Life Insurance Enterprises* (014811CR, $6)	Audits of life insurance enterprises' financial statements for periods ending after December 15, 1994

AICPA Services

Technical Hotline

.86 The AICPA Technical Information Service answers inquiries about specific audit, review, compilation and accounting problems.

Call toll-free (800) TO-AICPA.

Ethics Division

.87 The AICPA's Professional Ethics Division answers inquiries about the application of the AICPA Code of Professional Conduct. Practitioners may call any of the following numbers:

(201) 938-3181

(201) 938-3177

(201) 938-3186

Order Department

.88 To order AICPA products, write: AICPA Order Department, P.O. Box 2209, Jersey City, NJ 07303-2209; order via FAX, (800) 362-5066; or call (800) TO-AICPA (dept. #1). Prices do not include shipping and handling. When ordering, please specify the product number to ensure that you will receive the correct publication.

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Attachment 1

The Representation Letter in a SSARS Review Engagement (A pamphlet prepared by the Auditing Standards Division)

About the time your accountant completes the review of your entity's financial statements, you will be asked to sign a letter that, at first glance, may appear formidable, but really isn't. As management, you are asked to acknowledge that you, rather than the accountant, have primary responsibility for the financial statements and that to the best of your knowledge these statements are correct. The letter does not change or add to your fundamental responsibilities, nor does it relieve the accountant of any of his or her responsibilities. It simply clarifies the traditional roles that management and the accountant perform. Accountants refer to such letters as *representation letters.* The standards for review engagements, *Statements on Standards for Accounting and Review Services* (SSARS), now require that accountants obtain a representation letter from their review clients.

This pamphlet is for individuals who are unfamiliar with a representation letter and who may not have been asked to sign one before. Its purpose is to anticipate and answer your questions.

Why Is a Representation Letter Required?

The accountant's review report lends credibility to financial statements that are used by bankers, investors and others. The accountant must comply with rigorous standards that govern the process and procedures of a review. Those standards are established by the American Institute of Certified Public Accountants' Accounting and Review Service Committee, composed of CPAs, most of whom are practicing certified public accountants. Their recommendations are developed over extended periods and are widely circulated for comment to thousands of people, including regulatory bodies.

In November 1992, the Accounting and Review Services Committee issued SSARS No. 7, which makes obtaining a client representation letter a required procedure in a review engagement. That is why you will be asked to sign a representation letter.

What Are Management's Responsibilities?

Financial statements are management's representation. You as the manager of an entity have access to the most detailed information about the entity and have daily, first-hand exposure to transactions and other events reported in the financial statements.

As part of your stewardship role in management, you are responsible for the selection of accounting principles when alternatives are available. This is true even though you may be unfamiliar with the intricacies of accounting practices.

The accountant usually advises you in the preparation of financial statements and often drafts them for you, but this does not dilute your responsibility. The accountant makes inquiries and performs analytical procedures to review the financial statements and issues a review report on them. However, that does not lessen your responsibility for those statements.

A representation letter documents information relating to your knowledge of the entity and your intentions. It complements other procedures the accountant performs to review the financial statements.

Does a Representation Letter Benefit Management?

Yes, a representation letter has several benefits for management. It avoids misunderstandings and provides a checklist for important matters that affect the financial statements.

During the review, you will respond to many of the accountant's questions. For example, after identifying related party transactions, the accountant routinely asks whether management has knowledge of any other such transactions not already disclosed. Another example is an accountant's reliance on management's representation that it has title to all owned assets. The purpose of putting these representations in writing is to confirm the continued appropriateness of the information obtained in discussions with management.

Does Signing a Representation Letter Alter Responsibilities?

No. It simply affirms a responsibility that already exists. The representation letter does not lessen the accountant's responsibilities, whether for the conduct of the review or for the accountant's report on the financial statements. The representations made in a representation letter do not displace other essential review procedures. An inability to perform essential procedures would constitute a limitation on the scope of the review even if management were to provide representations covering such matters.

It is important that questions regarding representations be thoroughly explored and answered to the full satisfaction of all concerned. The accountant cannot issue a review report without this letter of representation. Without this letter in hand, the accountant is left to wonder if management has withheld information. Certainly, this might raise doubts in the accountant's mind about the reliability and completeness of management's oral responses to the accountant's inquiries.

Management Should Understand the Importance of the Representation Letter

The representation letter is not just "another form" to be signed. It is important to the accountant even though, year after year, its form and substance may go unchanged. Typically, it contains condensed but significant and wide-ranging representations. Even though the representation letter may be drafted by the accountant for your signature, the representations it contains are yours, and you should understand the full implications of statements in the letter.

Illustrative Representation Letter

The illustrative representation letter included in SSARS No. 1 (AR section 100) is reproduced in this pamphlet. The letter is addressed to the CPA firm. Because the accountant is concerned with events occurring through the date of his or her report that may require adjustment to or disclosure in the financial statements, the letter will probably bear the same date as the accountant's report. That date marks the completion of all significant review procedures.

(Date of Accountant's Report)

(To the Accountant)

In connection with your review of the (identification of financial statements) of (name of client) as of (date) and for the (period of review) for the purpose of expressing limited assurance that there are no material modifications that should be made to the statements in order for them to be in conformity with generally accepted accounting principles, we confirm, to the best of our knowledge and belief, the following representations made to you during your review.

1. The financial statements referred to above present the financial position, results of operations, and cash flows of (name of client) in conformity with generally accepted accounting principles. In that connection, we specifically confirm that—

   a. The company's accounting principles, and the practices and methods followed in applying them, are as disclosed in the financial statements.

b. There have been no changes during the (period reviewed) in the company's accounting principles and practices.

c. We have no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.

d. There are no material transactions that have not been properly reflected in the financial statements.

e. There are no material losses (such as from obsolete inventory or purchase or sales commitments) that have not been properly accrued or disclosed in the financial statements.

f. There are no violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency, and there are no other material liabilities or gain or loss contingencies that are required to be accrued or disclosed.

g. The company has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged.

h. There are no related party transactions or related amounts receivable or payable that have not been properly disclosed in the financial statements.

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

j. No events have occurred subsequent to the balance sheet date that would require adjustment to, or disclosure in, the financial statements.

2. We have advised you of all actions taken at meetings of stockholders, board of directors, and committees of the board of directors (or other similar bodies, as applicable) that may affect the financial statements.

3. We have responded fully to all inquiries made to us by you during your review.

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

Review of Financial Statements—Illustrative Representation Letter

A review of financial statements consists principally of inquiries of company personnel and analytical procedures applied to financial data. As part of a review of financial statements, the accountant is required to obtain a written representation from his or her client to confirm the oral representations made to the accountant. The enclosed representation letter is included for illustrative purposes only. The accountant may decide, based on the circumstances of the review engagement, that other matters should be specifically included in the letter and that some of the representations included in the illustrative letter are not necessary.

It would be worthwhile to discuss the letter with your accountant so that all agree as to the meaning and significance of the representations. Ask for an explanation of unfamiliar terms or phrases. (You may want definitions included in the letter.) Make sure any changed circumstances are reflected in the current year's letter and that generalizations not applicable to your entity have not been included inadvertently.

Finally, keep in mind these words which usually appear in the opening paragraph:

we confirm, to the best of our knowledge and belief...

The representations do not constitute a guarantee that the information given is correct but rather that it is, in good faith, your best knowledge and belief.

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Attachment 2

Understanding Compilation, Review and Audit (A pamphlet prepared by the Auditing Standards Division)

Reporting on Financial Performance

Almost every organization—whether it's a privately held business, a publicly owned corporation, or a nonprofit organization—must prepare reports on its financial performance. Such reports help owners and managers make operating decisions, enable creditors to evaluate loan applications, and provide individuals with information to make investment decisions.

The accounting profession recognizes that different entities have different accounting needs. Acknowledging these differences, the profession has developed standards that enable CPAs to offer a range of financial statement services to private companies.

Diverse Accounting Services for Diverse Needs

A CPA may provide a client with three distinct services involving financial statements. Each is designed to meet a different need.

A *compilation* is useful to small, privately held companies that need help in preparing their financial statements. A *review*, on the other hand, may be adequate for entities that must report their financial positions to third parties, such as creditors or regulatory agencies. Reviewed financial statements may also be useful to business owners who are not actively involved in managing their companies.

An *audit* is the third and most extensive service. An audit is appropriate for businesses that must offer a higher level of assurance to outside parties. An unqualified opinion from a CPA after an audit provides reasonable assurance to outside parties that the entity's financial statements fairly present its financial position and results of operation in accordance with certain accounting principles.

Compilation, review and audit services for private companies are explained in greater detail below.

Compilation

Preparing financial statements based on information provided by the entity's management.

Through compilation services, a CPA prepares monthly, quarterly, or annual financial statements. However, he or she offers no assurance as to whether material, or significant, changes are necessary for the statements to be in conformity with generally accepted accounting principles—the set of rules regarding financial accounting and reporting. During a compilation, the data is simply arranged into conventional financial statement form. No probing is conducted beneath the surface unless the CPA becomes aware that the data provided is in error or is incomplete.

However, before agreeing to perform a compilation, a CPA will take a "common sense" look at the organization's accounting system to decide whether the client needs other accounting services, such as help in adjusting the accounting records.

Here's What a Compilation Entails:

The CPA becomes familiar with the accounting principles and practices common to the client's industry and acquires a general understanding of the client's transactions and how they are recorded.

After compiling the financial statements, the CPA is obliged to read them and consider whether they are appropriate in form and free from obvious material errors. The CPA then issues a standard report that says, in effect, that the financial statements were compiled, but because they were not audited or reviewed, no opinion is expressed.

Compilation standards permit an accountant to compile financial statements that omit footnote disclosures required by generally accepted accounting principles. This is allowable as long as the omission is clearly indicated in the report and there is no intent to mislead users. However, when footnote disclosures have been left out, the CPA adds a third paragraph to the compilation report stating that management has elected to omit disclosures normally required by generally accepted accounting principles. This paragraph lets the user know that if the financial statements contained this information, it might affect the user's conclusions.

A compilation is sufficient for many private companies. However, if a business needs to provide some degree of assurance to outside groups that its financial statements are reliable, it may be necessary to engage a CPA to perform a review.

Review

Inquiry and analytical procedures applied to financial statements.

A private company may engage a CPA to perform a review of its financial statements and issue a report that provides limited assurance that material changes to the financial statements are not necessary. With respect to reliability and assurance, a review falls between a compilation, which provides no assurance, and the more extensive assurance of an audit.

Before a review, the CPA may have to compile the financial statements; however, in all cases, the financial statements are management's statements, not the CPA's. Management must have a sufficient understanding of the financial statements to assume responsibility for them.

Two other factors differentiate a review from a compilation—the CPA must remain independent of the client during a review, and all appropriate disclosures must be included in the reviewed statements.

Here's What a Review Entails:

The CPA obtains a working knowledge of the industry in which the entity operates and acquires information on key aspects of the organization, including operating methods, products and services, and material transactions with related parties.

The CPA will then make inquiries concerning such financial statement related-matters as accounting principles and practices, recordkeeping practices, accounting policies, actions of the board of directors, and changes in business activities. Then the CPA will apply analytical procedures designed to identify unusual items or trends in the financial statements that may need explanation. Essentially, a review is designed to see whether the financial statements "make sense" without applying audit-type tests.

Keep in mind that during a review, a CPA does not confirm balances with banks or creditors, observe inventory counting, or test selected transactions by examining supporting documents. However, in many instances, a review—with its limited assurance—may be adequate for a business or its creditors. If more assurance is necessary, the organization may need to engage a CPA to perform an audit.

Audit

Includes such procedures as confirmation with outside parties, observation of inventories, and testing selected transactions by examining supporting documents.

A public or private company may engage a CPA to audit its financial statements and to issue a report that provides the highest level of assurance that the financial statements are presented fairly in conformity with generally accepted accounting principles.

In an audit, as in a review, the CPA must be independent of the client and the financial statements must contain all required disclosures.

Here's What an Audit Entails:

To gather evidence on the reliability of the financial statements, the CPA performs "search and verification" procedures. In an audit, the CPA generally confirms balances with banks or creditors, observes inventory counting, and tests selected transactions by examining supporting documents. In addition, the CPA contacts sources outside the client organization to gather information that may be more objective than that obtained from internal sources. For example, the CPA usually obtains written confirmation from a client's customers about amounts owed to the client at a specific date. By accumulating this type of evidence, the CPA tries to reduce the risk that the financial statements will be materially misstated.

The auditor then issues a report stating that the financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles.

An audit is planned and performed with an attitude of professional skepticism; that is, the auditor designs the audit to provide "reasonable assurance" that significant errors or fraud are detected. However, irregularities or fraud concealed through forgery or collusion may not be found because the auditor is not trained to catch forgeries, nor will customary audit procedures detect all conspiracies.

An audit provides a reasonable level of assurance that the financial statements are free of material errors and fraud. An audit does not, however, provide a guarantee of accuracy.

What Services Do You Need?

Compilation

CPA prepares financial statements from information provided by management.

A compilation is useful when limited in-house capabilities for preparing financial statements exist.

Review

CPA applies inquiry and analytical procedures to financial statements provided by management to determine if they are reasonable.

A review provides limited assurance that no material changes need to be made to the financial statements.

Audit

CPA examines financial statements by conferring with outside parties, completing physical inspections and observations, and testing selected transactions by examining supporting documents.

An audit provides the highest level of assurance that the financial statements fairly represent the entity's financial position and results of operation in accordance with generally accepted accounting principles.

AAM Section 8020
Credit Union Industry Developments—1993

Industry and Economic Developments

.01 The nation's credit union system has responded in a positive fashion to recent political and economic changes. The financial condition of the credit union industry continues to grow stronger as evidenced by strong asset growth, an increasing ratio of capital to total assets, and a decline in loan delinquencies. The National Credit Union Share Insurance Fund (NCUSIF), which insures member share and savings accounts, also remains strong. Continued consumer confidence in credit unions and their insurance funds has resulted in substantial membership and asset growth during recent periods.

.02 Credit unions, along with virtually all other kinds of financial institutions, are enjoying the benefits of relatively wide interest rate spreads, that is, the difference between the rates they charge on loans and the rates they pay to attract funds. In times of declining interest rates, credit unions tend to lag behind the market in lowering their rates on members' share and savings accounts with the result that they are paying higher rates than other financial institutions. These slightly higher rates, combined with lingering concerns about the financial stability of banks and savings institutions, have fueled increases in member share and savings accounts for many credit unions.

.03 Lending by credit unions was able to keep pace with share growth, at least during the first half of 1993. Because credit unions do not have to build capital as aggressively as other financial institutions, some have been able to cut loan rates faster than other kinds of institutions, thereby increasing their market share. Even with that advantage, however, credit unions' share of the lending market remains relatively low because credit unions face stiff competition from nonfinancial institution players such as captive car finance companies and corporate credit card issuers.

.04 Continued regulatory concerns about concentrations of credit risk, primarily in real estate loans, have lead some credit unions to search for new lending markets. Some, for example, are establishing connections with automobile dealers to increase their share of the auto loan market.

.05 Some credit unions have attempted to increase yields by increasing the risk they are willing to accept, for example, adopting more lenient lending policies that may include business lending, investing in new and complex financial instruments, and the funding of longer term assets with shorter term liabilities.

.06 As always, auditors should be alert to the audit risk implications of practices that place credit unions at a high level of risk of loss. The various risks associated with these actions may be significant, and auditors should be alert to changes in loan and investment policies and to the effect of those changes on audit risk.

Regulatory Developments

National Credit Union Administration Initiatives

.07 *Allowance for Loan Losses.* The adequacy of allowances for loan losses is always a primary concern for both auditors and regulators of credit unions. In December 1992, the National Credit Union Administration (NCUA) issued a final rule amending part 702 of its rules and regulations, "Reserves," to require credit unions to provide an allowance for loan losses for regulatory purposes that is sufficient to cover specifically identified losses as well as estimated losses inherent in their loan portfolios. The purpose of this rule is to better conform the method of determining the allowance for regulatory purposes with generally accepted accounting principles (GAAP). However, because of the subjectivity involved in determining loan loss allowances, differences between allowances recorded for regulatory purposes and those recorded for GAAP purposes may still occur. The Financial

Accounting Standards Board's (FASB's) Emerging Issues Task Force (EITF) Issue No. 85-44, *Differences Between Loan Loss Allowance for GAAP and RAP,* recognizes that institutions may sometimes record different loan loss allowances under regulatory accounting principles (RAP) and GAAP. In EITF Issue No. 85-44, the EITF reminded auditors that they should be skeptical of such differences and should justify them based on the facts and circumstances associated with each engagement.

.08 *Supervisory Committee Audits and Verifications.* In July 1993, the NCUA Board issued a final rule that amended its regulations governing supervisory committee audits and verifications. The amendments allow auditors who are engaged to perform supervisory committee audits to use nonstatistical samples in performing certain substantive testing of members' accounts consistent with generally accepted auditing standards (GAAS) (see *Federal Register,* vol. 58, no. 140, July 23, 1993).

.09 *Access to Supervisory Committee Workpapers by Authorized NCUA Employees.* The NCUA Board recently issued final rules providing for regulatory review of workpapers that support supervisory committee audits (see *Federal Register,* vol. 58, no. 140, July 23, 1993). The rules state:

> The supervisory committee and/or its independent auditor shall be responsible for the preparation and the maintenance of original working papers to support each supervisory committee audit. Such original working papers shall be made available at the credit union offices or within a reasonable proximity by the supervisory committee and its independent auditors for review by any authorized employee of NCUA. If the credit union supervisory committee fails to do so, NCUA can reject the supervisory committee audit as inadequate in meeting the requirements.

.10 The AICPA has developed guidelines to assist auditors in fulfilling their obligations to provide access to workpapers by regulators while maintaining control over the workpapers. For a complete copy of these guidelines, refer to the "Notice to Practitioners, Guidance for Independent Auditors When Required to Provide Access to or Photocopies of Workpapers to Regulators," published in the July/August 1993 issue of the *CPA Letter.*

.11 When required by law, regulation, or audit contract to provide regulators with access to workpapers, auditors should—

- Ensure that the client and the audit team are aware that the workpapers may be reviewed by regulators, and have the client acknowledge in the engagement letter that the workpapers are the property of the auditor but the regulator may be provided with access to workpapers, upon request in accordance with the law, regulation, or audit contract.
- Ensure that a request for access to workpapers by the regulator is in writing. The auditor should communicate specific details (for example, date, time, and location) to the client of how access to the workpapers will be provided, and request that the client acknowledge to the auditor in writing that the auditor is required to provide such access to the regulator. In the event that the client does not comply with this request, the auditor may wish to consult his or her own legal counsel.
- Maintain control over the workpapers at all times. Unless expressly provided for by law, regulation, or audit contract, only workpapers related to specific requests should be made available.

.12 *Final Rule on Investment and Deposit Activities.* On June 30, 1993, the NCUA issued a rule revising its high-risk test for collateralized mortgage obligations (CMOs) and real estate mortgage investment conduits (REMICs) (see *Federal Register,* vol. 58, no. 124, June 30, 1993). The new test includes an average life test, an average life sensitivity test, and a price test. The revised rules may affect the classification and valuation of investments in a credit union's financial statements in that NCUA may seek early disposition of such investments when, in their opinion, they constitute a significant threat to its continued sound operation. Such forced dispositions can also negatively affect the credit union's liquidity, earnings, and capital positions.

Audit Issues and Developments

Audit Issues

.13 *Derivatives and Other High-Risk Investments.* In recent years, there has been a growing use of innovative financial instruments that often are very complex and can involve a substantial risk of loss. Users and issuers of such instruments must have the expertise necessary to understand and manage the related risks. As discussed below, auditors should also be familiar with such instruments and the associated risks. One class of these instruments—derivatives—requires particular attention.

.14 Derivatives are complex financial instruments whose values depend on the values of one or more underlying assets or financial indexes. Derivatives in which credit unions are permitted to invest include—

- Mortgage-backed securities issued or fully guaranteed by an agency of the U.S. Government.
- Mortgage-related derivatives such as stripped mortgage-backed securities and collateralized mortgage obligations.
- Asset-backed security residuals, except asset-backed residuals supported by installment loans, leases, or revolving lines of credit.

By reconfiguring cash flows associated with underlying assets, an issuer can create asset-backed securities that meet the needs of and are attractive to various potential users by isolating, enhancing, or diluting one or more of credit, liquidity, interest rate, and other risks inherent in the underlying cash flows. For example, through mortgage-backed securities, the issuer can enhance the marketability of underlying mortgage loans by spreading liquidity and credit risk across broad pools, or by providing a higher yield to those users willing to accept a higher concentration of the risks associated with specific collateral cash flows. Similarly, users find certain derivatives attractive because they can purchase the risks and rewards they desire most, or can synthetically create a security with the desired risk and reward characteristics.

.15 Increased volatility of interest rates, foreign exchange rates, and commodity and other prices has also fostered tremendous innovation in financial products to meet the needs of users attempting to hedge or alter the related risks. Swaps, for example, are financial contracts in which two parties exchange streams of payments over a period of time. An entity with debt that carries variable interest rates (such as an entity that has short-term certificates of deposit) might swap interest rate payments on an agreed-upon principal amount with a counterparty by paying a fixed rate and receiving a variable rate. The entity locks into an interest rate for the term of the swap, reducing the risk that increases in interest rates will increase the entity's cost of funds as its liabilities are refunded or related interest rates are reset. The entity takes on other risks, however, such as the risk that the counterparty could default on its payments. By locking into fixed rates, the entity will no longer benefit from interest rate decreases during the term of the swap and it is often costly to terminate a swap. Further, the fair value of derivatives can be volatile in periods of changing market conditions.

.16 *Accounting.* Accounting for derivatives is complex. Given the constant innovation and complexity of derivatives, accounting literature does not explicitly cover some derivatives; however, several related projects are underway.

.17 The FASB has been carrying out a major project on the recognition and measurement of financial instruments, which has already resulted in the issuance of FASB Statements of Financial Accounting Standards No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (AC F25), No. 107, *Disclosures about Fair Value of Financial Instruments* (AC F25), and No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (AC I80), and FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts* (AC B10), that address related issues. The FASB's project includes a comprehensive review of accounting for hedging and risk-adjusting derivatives. Also, the International Accounting Standards Committee is in the process of developing an international accounting standard for financial instruments.

.18 Several accounting issues involving derivatives have also been addressed by the FASB's EITF. Other guidance is provided by FASB Statements No. 52, *Foreign Currency Translation* (AC F60), and No. 80, *Accounting for Futures Contracts* (AC F80). In addition, the AICPA Issues Paper No. 86-2, *Accounting for Options,* discusses various matters related to options.

.19 *Auditing.* AICPA Statement on Auditing Standards (SAS) No. 22, *Planning and Supervision* (AU section 311), requires that auditors understand the events, transactions, and practices that, in their judgment, may have a significant effect on the financial statements. Accordingly, auditors should carefully consider the various risks involved with investments in derivatives and other complex securities as they plan their audits and should—

1. Assess management's expertise in monitoring, evaluating, and accounting for the securities.
2. Ensure that the credit union has set appropriate policies and procedures for investment in high-risk securities and that there is adequate oversight by the board of directors or supervisory committee.
3. Involve specialists, when necessary, in valuing and auditing these investments.

.20 Auditors should be familiar with the NCUA's *Rules and Regulations* and its Interpretive Ruling and Policy Statement related to investments, which are discussed further in the "Regulatory Developments" section. Certain rules and regulations may affect the classification and valuation of a credit union's investments.

.21 *Related-Party Transactions.* Certain related-party transactions are currently receiving substantial public and regulatory scrutiny. These transactions include—

- Loans to credit union officers and directors or their affiliates.
- Fees or commissions paid to credit union officers and directors or their affiliates.
- Other arrangements, including purchased goods or services from and contracts with officers and directors or their affiliates.

SAS No. 45, *Omnibus Statement on Auditing Standards—1983* (AU section 334), provides guidance on procedures that should be considered by auditors in order to identify related-party relationships and transactions and to satisfy themselves concerning the accounting for and disclosure of transactions with related parties.

.22 *Asset Quality and Other Valuation Issues.* Credit quality and other asset quality issues associated with business and consumer loans, real estate portfolios, troubled debt restructurings, foreclosures and in-substance foreclosures, off-balance-sheet financial instruments, and other assets require critical attention in audits of the financial statements of credit unions. Auditors should obtain reasonable assurance that management has recorded an adequate allowance based on all factors relevant to the collectibility of the loan portfolio. The subjectivity of determining loan loss allowances, combined with continued economic uncertainty and intense regulatory scrutiny, reinforces the need for careful planning and execution of audit procedures in this area.

.23 Lack of an asset impairment evaluation system and the failure of a credit union to adequately document its criteria and methods for determining loan loss allowances may indicate a material weakness in the credit union's internal control structure and will generally increase the extent of judgment that must be applied by both regulatory examiners and auditors in evaluating the adequacy of management's allowances and will increase the likelihood that differences will result. The guidance in the AICPA Audit and Accounting Guide *Audits of Credit Unions* and in SAS No. 57, *Auditing Accounting Estimates* (AU section 342), should be followed in auditing loan loss allowances. Other sources of information that may be useful in auditing loan loss allowances of credit unions include SAS No. 11, *Using the Work of a Specialist* (AU section 336), the AICPA Auditing Procedure Study *Auditing the Allowance for Credit Losses of Banks,* and the AICPA Audit and Accounting Guide *Guide for the Use of Real Estate Appraisal Information.*

.24 As with credit risk, other valuation issues involve many subjective assumptions. For example, the expected effects of prepayments on loans in portfolios and the types of income and expense items included in valuations of loan servicing assets have a significant impact on the recorded values of those assets. High levels of prepayments of mortgage loans, for example, have resulted in impairment of assets such as purchased mortgage servicing receivables and interest-only securities. Evaluation and recognition of impairment due to prepayments should include consideration of the credit union's aggregation policy, discount rates, and assumptions about prepayment rates.

.25 Further, falling interest rates have created an environment in which transactions involving gains-trading of securities, refinancing of loans, restructuring of nonperforming assets, origination of loans to facilitate the sale of real estate owned, and other asset dispositions all require specific attention. Such transactions require an understanding of the specific situations so that auditors may carefully assess and control audit risk.

.26 A credit union's exposure to changing interest rates should be considered in the auditor's evaluation of the credit union's ability to continue as a going concern, including the effect such changes could have on profitability, liquidity, and capital adequacy.

Audit Developments

.27 *Revised Audit and Accounting Guide.* In December 1992, the AICPA Credit Unions Committee issued a revised Audit and Accounting Guide *Audits of Credit Unions*, which supersedes the edition of the guide originally published in 1986. The principal objectives of the revised guide are to heighten auditors' awareness of the complex issues encountered in audits of credit unions' financial statements and to alert auditors to the need for specific industry knowledge and skills. The revised guide addresses the broad issues of interest rate risk, liquidity, asset quality, and management controls, as well as specific concerns such as mortgage-related derivatives and off-balance-sheet financial instruments. It also provides for additional disclosures related to members' share and savings accounts, including information about maturities, interest rates, restrictions on the payment of interest, and the priority of other liabilities over shares in claims against the assets of the credit union. The revised guide also establishes accounting guidance for NCUSIF premium assessments. The auditing provisions of the revised guide are effective prospectively to financial statements of credit unions for fiscal years beginning on or after December 15, 1992.

.28 *Service Auditor Reports.* In April 1992, the AICPA's Auditing Standards Board issued SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AU section 324), which provides guidance on the factors auditors should consider when auditing the financial statements of an entity that uses a service organization to process certain transactions. SAS No. 70 (AU section 324) also provides guidance for auditors who issue reports on the processing of transactions by a service organization for use by other auditors.

.29 Because using service organizations affects both the auditor's understanding of the internal control structure and assessment of control risk, the guidance in SAS No. 70 (AU section 324) should be considered by auditors of credit unions that use service bureaus for processing significant information (for example, general ledger and trial balances, loan and member share transactions, or investment information), or that issue reports on the processing of transactions by credit union service organizations for use by other auditors. SAS No. 70 (AU section 324) is effective for service auditors' reports dated after March 31, 1993.

.30 *Reporting on Mortgage Banking Activities.* Auditors who are engaged to report on mortgage banking activities of credit unions should be aware of the following developments.

.31 *MBA USAP.* The Mortgage Bankers Association of America (MBA) is revising its *Uniform Single Audit Program for Mortgage Bankers* (USAP). The program was introduced in 1965 and has gained acceptance by investors as a useful guide for engagements that address the servicing functions of mortgage banking entities. Since the last USAP revision in 1983, changes in auditing standards have redefined the nature and reporting requirements of similar engagements. The MBA is considering revising the USAP as an examination level under the AICPA's Attestation Standards. However, pending completion of the USAP revision, the MBA has suggested that entities follow the reporting and other requirements of the 1983 USAP.

.32 SAS No. 70 (AU section 324) provides guidance to auditors of service organizations (such as loan servicers) on reporting on certain aspects of service organizations' internal control structures that can be used by other auditors, and also provides guidance on how other auditors should use such reports.

.33 *Freddie Mac.* The Federal Home Loan Mortgage Corporation (Freddie Mac) issued a revised *Compliance Reporting Guide* that supersedes its previous guide issued in June 1991. The revised guide addresses the scope of compliance attestation engagements at entities that sell or service mortgage loans under Freddie Mac programs, sets forth certain procedures to be performed, and presents required reporting formats.

.34 The Freddie Mac guide includes an agreed-upon-procedures-level attestation engagement to be performed on the seller/servicer's assertions about its compliance with Freddie Mac eligibility requirements and is effective for reporting on periods ending June 30, 1993 and thereafter. Seller/servicers were given copies of the guide with instructions to provide copies to their auditors.

Accounting Developments

FASB Financial Instruments Project

.35 The FASB's agenda continues to include a project on financial instruments that encompasses three primary segments: disclosures, distinguishing between liabilities and equity, and recognition and measurement. In addition to these three primary segments, the FASB has addressed several narrower issues within the overall scope of the project. Some of the current developments of the project are described in the following sections.

.36 *Impairment of a Loan.* In May 1993, the FASB issued FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan* (AC I08), which addresses the accounting by creditors for impairment of certain loans. The Statement is applicable to all creditors and to all loans, uncollateralized as well as collateralized, except large groups of smaller balance homogeneous loans that are collectively valued for impairment, loans that are measured at fair value or at the lower of cost or fair value, leases, and debt securities as defined in FASB Statement No. 115 (AC I80). It applies to all loans that are restructured in a troubled debt restructuring involving a modification of terms.

.37 FASB Statement No. 114 (AC I08) requires that impaired loans that are within its scope be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or as a practical expedient, at the loan's observable market price or the fair value of collateral if the loan is collateral-dependent.

.38 The Statement amends FASB Statement No. 5, *Accounting for Contingencies* (AC C59), to clarify that a creditor should evaluate the collectibility of both contractual interest and contractual principal of all receivables when assessing the need for a loss accrual. The Statement also amends FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructuring* (AC D22), to require a creditor to measure all loans that are restructured in a troubled debt restructuring involving a modification of terms in accordance with its provisions.

.39 The Statement applies to financial statements for fiscal years beginning after December 15, 1994. Earlier application is encouraged.

.40 Sources of guidance relevant to auditing loan loss allowances of credit unions are described in paragraph .23.

.41 Some credit unions may adopt the provisions of the Statement prior to its effective date. Auditors of the financial statements of such credit unions should carefully consider the implications of applying the new provisions of the Statement on audit risk. Aspects of applying the new Statement that warrant particular consideration include—

- Proper identification of all loans to which the Statement should be applied.

- The reasonableness of estimates of future cash flows and interest rates used in discounting.
- The appropriateness of amounts used to measure impairment if alternatives to present value amounts, such as fair values of collateral or observable market prices, are used.
- The relationship between the identification of impaired loans under the statement and the classification of loans under the regulatory classification system.
- The presentation of accrued interest receivable and its relationship to valuation allowances.
- The relevance of concepts of nonperforming or nonaccrual assets.

.42 *Investments in Debt and Equity Securities.* In May 1993, the FASB issued FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (AC I80), which addresses the accounting and reporting for investments in equity securities that have readily determinable fair values (previously addressed by FASB Statement No. 12, *Accounting for Certain Marketable Equity Securities* [AC I89]) and for all investments in debt securities. Statement No. 115 (AC I80) does not cover securities accounted for by the equity method and investments in consolidated subsidiaries. Statement No. 115 (AC I80) establishes three categories of reporting debt and marketable equity securities:

- Held-to-maturity securities (debt securities that the credit union has the positive intent and ability to hold to maturity), to be reported at amortized cost
- Trading securities (debt and equity securities that are bought and held principally for the purpose of selling them in the near future), to be reported at fair value, with unrealized gains and losses included in earnings
- Available-for-sale securities (debt and equity securities not classified as either held-to-maturity or trading), to be reported at fair value, with unrealized gains and losses excluded from earnings and reported in a separate component of equity until realized

Mortgage-backed securities that are held for sale in conjunction with mortgage banking activities (as described in FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities* [AC Mo4]), are classified as trading securities. Mortgage-backed securities that are currently not held-for-sale in conjunction with mortgage banking activities may be classified in one of the other two categories, as appropriate.

.43 FASB Statement No. 115 (AC I80) also requires credit unions to determine whether declines in the fair value of individual securities classified as either held-to-maturity or available-for-sale below their amortized cost bases are other than temporary. For example, if it is probable that an investor will be unable to collect all amounts due according to the contractual terms of a debt security not impaired at acquisition, an other-than-temporary impairment is considered to have occurred. If such a decline is judged to be other than temporary, the cost basis of the individual security should be written down to fair value as the new cost basis, with the amount of the write-down included in earnings (that is, accounted for as a realized loss).

.44 The Statement also specifies the accounting treatment for transfers between categories.

.45 The Statement (paragraph 8 [AC I80.105]) indicates that certain changes in circumstances may cause the enterprise to change its intent to hold a certain security to maturity without calling into question its intent to hold other debt securities to maturity in the future (for example, evidence of a significant deterioration in the issuer's creditworthiness or a change in tax law that eliminates or reduces the tax-exempt status of interest on the debt security. In addition, other events that are isolated, nonrecurring, and unusual for the reporting enterprise that could not have been reasonably anticipated may cause an entity to sell or transfer a held-to-maturity security without necessarily calling into question its intent to hold other debt securities to maturity. Such sales and transfers of held-to-maturity securities are expected to be rare.

.46 An entity shall not classify a debt security as held-to-maturity if the enterprise has the intent to hold the security for only an indefinite period. Consequently, a debt security should not, for example, be classified as held-to-maturity if the enterprise anticipates that the security would be available to be sold in response to changes in market interest rates and related changes in the security's prepayment risk, needs for liquidity, changes in the availability of and the yield on alternative investments, changes in funding sources and terms, and changes in foreign-currency risk.

.47 FASB Statement No. 115 (AC I80) is effective for fiscal years beginning after December 15, 1993. It specifically prohibits retroactive restatement of prior financial statements. Although typically Statement No. 115 (AC I80) would be initially applied as of the beginning of a fiscal year (such as January 1, 1994), entities are permitted to initially apply the Statement as of the end of an earlier annual period for which financial statements have not been issued (with no restatement of interim periods).

.48 Since all credit unions with a calendar fiscal year must classify their investments in securities in accordance with FASB Statement No. 115 (AC I80) as of January 1, 1994, those credit unions will also be able to apply the Statement as of December 31, 1993, if they wish to do so in their 1993 annual financial statements. Thus, auditors should be aware of some of the issues that are likely to arise when the Statement is applied. Auditing financial statements involving the classification of investments in debt and equity securities pursuant to FASB Statement No. 115 (AC I80) may involve a high degree of judgment about matters such as the following:

- How auditors should evaluate subjective exceptions for sales of securities designated as held-to-maturity (including the interpretation of restrictive terms such as *isolated, nonrecurring,* and *unusual*)
- How auditors should evaluate the ability of a credit union to hold securities to maturity, particularly when going-concern issues arise
- Whether cash flow projections are needed in conjunction with assessing a credit union's ability to hold securities to maturity
- How to evaluate whether impairments of investments are other than temporary

Consensus Decisions of the FASB's Emerging Issues Task Force

.49 The FASB's EITF frequently discusses accounting issues involving financial instruments, real estate, or transactions of similar importance to credit unions.

.50 In Issue No. 93-1, *Accounting for Individual Credit Card Acquisitions,* the EITF reached a consensus that credit card accounts acquired individually should be accounted for as originations under FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases* (AC L20), and EITF Issue No. 92-5 (see the following discussion).

.51 In Issue No. 92-10, *Loan Acquisitions Involving Table Funding Arrangements,* the EITF reached a consensus that a mortgage loan acquired by a mortgage banking enterprise in a table funding arrangement should be accounted for as a purchase of the loan if the loan is legally structured as an origination by the correspondent and if the correspondent is independent of the mortgage banking enterprise. If any criterion set forth in the consensus is not met, the loan should be accounted for by the mortgage banking enterprise as an originated loan.

.52 In Issue No. 92-5, *Amortization Period for Net Deferred Credit Card Origination Costs,* the EITF reached a consensus that credit card origination costs that qualify for deferral pursuant to paragraph 6 of FASB Statement No. 91 (AC L20.105) should be netted against the related credit card fee, if any, and the net amount should be amortized on a straight-line basis over the privilege period. If a significant fee (relative to the related costs) is charged, the privilege period is the period that the fee entitles the cardholder to use the card. If there is no significant fee, the privilege period should be one year.

.53 In addition, the EITF reached a consensus that for both purchased and originated credit cards, an entity should disclose its accounting policy, the net amount capitalized at the balance sheet date, and the amortization period(s) of credit card fees and costs.

.54 In Issue No. 92-2, *Measuring Loss Accruals by Transferors for Transfers of Receivables with Recourse*, the EITF reached a consensus that the obligation recorded at the date of sale in connection with the recourse provisions of a transfer of receivables should include all probable losses over the life of the receivables transferred and not only those measured in conformity with FASB Statement No. 5 (AC C59), prior to the date of transfer. The EITF also reached a consensus that recognition of the recourse obligation on a present value basis, as defined, would be acceptable if the timing of the estimated cash flows can be reasonably estimated.

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.55 This Audit Risk Alert replaces *Credit Union Industry Developments—1992.*

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.56 Practitioners should also be aware of the economic, regulatory, and professional developments in *Audit Risk Alert—1993* [AAM section 8010] and *Compilation and Review Alert—1993* [AAM section 8015].

[The next page is 8071.]

AAM Section 8030
Health Care Industry Developments—1993

Industry and Economic Developments

.01 Continuing economic uncertainty, governmental budget constraints, and rising operating costs have continued to intensify the financial pressures on providers of health care services. The advent of a new administration in the White House, with health care reform as one of its top priorities, brings with it a host of new implications for change in the industry. The Clinton administration is currently studying various issues and alternatives relating to health care reform. President Clinton is expected to present an extensive set of recommendations in the near future. The plan will then go to Congress, where the time frame in which it will become legislation is uncertain. Major elements of the plan are likely to include the following:

- Comprehensive administrative reforms
- New taxes on providers
- Price control measures or other short-term cost control measures
- Guidelines on permissible relationships among providers

.02 A number of the reforms are likely to have a significant effect on how health care providers manage their operations. Administrative changes may have internal control structure implications. Other changes are apt to raise new accounting issues, the consequences of which will need to be carefully evaluated by auditors. Past experience indicates that the adequacy of internal control structures over financial reporting, the propriety of accounting policies, and the adequacy of financial statement disclosures require careful consideration in circumstances such as those that prevail in the health care industry.

.03 Relationships among the various providers that comprise the health care system have long been a concern to both government regulators and others. (See the section entitled, "Hospital-Physician Relationships" of this Audit Risk Alert (paragraphs .16-.21).) In anticipation of coming reforms, the industry is already beginning to restructure. Hospitals are banding together locally and regionally, both formally, for example, through mergers and acquisitions, and informally, for example, through affiliations. Physicians and hospitals are exploring the creation of new business arrangements, which may range from loose affiliations to sophisticated integrated delivery systems that combine inpatient, outpatient, and physician delivery services into one organization. Some providers are also integrating vertically, expanding into alternate delivery systems to create a continuum of care within the communities they serve. Such restructurings, joint ventures, and alliances may also prompt new accounting issues. Some may be associated with work force reductions, facility closings, or the discontinuation of certain operations. Others concern the form and substance of transactions and basis of accounting. Still other issues pose regulatory concerns by creating relationships that may be prohibited under certain governmental reimbursement schemes. In such circumstances, auditors should be aware of the heightened possibility that related party transactions or misstatements of the financial statements as a result of illegal acts may occur.

.04 In addition to reform initiatives, other forces continue to exert pressure on the industry. Such forces include declines in third-party payment rates, declines in the availability of capital, and shifts to lower cost service providers. These forces, too, may result in added audit risk, particularly as it relates to the measurement and disclosure of unusual and complex transactions. In some cases, such factors, in combination with a sluggish or uncertain regional economy, may result in the inability of a number of providers to meet their obligations as they become due. Such conditions should prompt auditors to carefully consider the provisions of Statement on Auditing Standards (SAS) No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going*

Concern (AU section 341), which requires auditors to evaluate, based on the results of audit procedures performed, whether there is substantial doubt about an entity's ability to continue as a going concern.

.05 Economic trends and developments that relate to specific segments of the health care industry are discussed in the following paragraphs.

Hospitals

.06 The hospital industry is facing the financial stress of coping with increasing price resistance while attempting to care for an aging, more costly patient population. Third-party administrators, health maintenance organizations (HMOs), preferred provider organizations, and other third-party managed care organizations are pressuring hospitals to move patients out of hospitals and into less costly treatment settings as quickly as possible. The hospitals are left with the highest-cost cases. At the same time, such organizations are pressuring hospitals to provide discounts, challenging the utilization of services, and otherwise resisting hospitals' efforts to pass higher rates on to their customers. These pressures, coupled with conditions such as overstaffing, outdated facilities, high levels of uncompensated care, and excess capacity, also should prompt auditors to consider the provisions of SAS No. 59 (AU section 341), described previously.

.07 Some hospitals are also experiencing increases in accounts receivable, and collections that are proceeding at a slower pace than in previous years. Part of the slowdown in collections results from the financial difficulties of third-party payers. The shortage of funds in a number of state Medicaid programs has resulted in significant delays in the payment of approved Medicaid claims. In addition, troubled managed care companies and insurance companies have delayed payments to providers. Increasingly, hospitals are also encountering external patient-billing auditors hired by third-party payers to *audit* bills received from hospitals to identify charges that may not be part of their coverage or that are considered excessive. Auditors should consider whether increases in accounts receivable indicate factors that result in increased audit risk.

HMOs

.08 The pressure exerted by HMOs on hospitals, as well as on others with whom they deal, appears to be holding down increases in costs relating to hospitals, prescription drugs, and doctors' services. It also appears that many providers of health care services to HMOs are holding down price increases as a result of anxiety about pending health care reforms.

.09 At the same time, HMOs are benefiting from widespread changes in health care insurance patterns. The popularity of HMOs is rising, as consumers opt to take advantage of rates that are lower than those of traditional health insurance and coverage that is sometimes more extensive. As a result, membership in HMOs is growing rapidly.

.10 These two factors are expected to result in sizable increases in earnings for most HMOs. In light of the current focus on health care costs, some HMOs may be reluctant to report substantial earnings increases for fear of being seen as profiteers. Thus, even though the circumstances might tempt auditors to assess audit risk at lower than normal levels, they should be alert to the possibility of transactions or changes in accounting policies that are intended to create reserves against future losses or otherwise result in a more level stream of earnings.

.11 Although the outlook for the HMO industry, as a whole, is considered by industry observers to be favorable, auditors should be aware that certain HMOs are experiencing financial difficulties. In auditing the financial statements of such HMOs, auditors should be especially alert to the following conditions or events that may threaten the HMOs' continued existence or be symptomatic of a growing problem: (1) failure to comply with state licensure requirements that pertain to financial solvency (such as requirements to maintain a specified degree of liquidity or minimum surplus balances); (2) failure to comply with Medicare/Medicaid contract provisions regarding financial solvency; (3) inability to meet state requirements to fund insolvency pools; and (4) negative enrollment trends.

Nursing Homes

.12 The nursing home segment of the health care industry is also experiencing increasing financial pressures. Many nursing homes receive most of their funds from state Medicaid programs. As a result of the fiscal stresses sustained by states during the recent recession, a number of nursing homes have experienced cutbacks in Medicaid payment rates, a slowdown in receipt of their Medicaid payments, or both.

.13 At the same time, the nursing home industry is becoming increasingly resource intensive. Pressure from third-party payers is forcing hospitals to shorten hospital stays by discharging patients sooner than was usual in the past; a number of these patients go to nursing homes to finish recuperating. As a result, nursing homes are treating sicker patients who require more costly care. The combination of higher-cost patients and Medicaid rate reductions is placing increasing financial stress on the entire nursing home segment of the health care industry. In addition, nursing homes that have historically relied on private-payer residents are withstanding shifts in their resident mix as the economic downturn forces more elderly individuals to become Medicaid beneficiaries. The financial stress is further compounded as nursing homes face increasing competition from lower-cost, long-term care providers such as home health and personal care agencies.

.14 Such challenges are likely to result in increased audit risk as clients attempt to manage or fine-tune their balance sheets and income statements. Auditors should be alert to issues relating to the collectibility of receivables (particularly from third-party payers), the classification of debt, the reasonableness of accounting estimates, and other items that are susceptible to accounting manipulation. Auditors should also carefully consider the provisions of SAS No. 59 (AU section 341).

Industry Data

.15 Auditors may find other useful information about the health care industry in a number of publications. A listing of publications that may provide auditors with relevant background information is included as appendix A (paragraph .62).

Regulatory and Legislative Developments

Hospital-Physician Relationships

.16 Physicians are often able to significantly influence Medicare and Medicaid payments to hospitals through referrals and admissions. As a result, relationships that require hospitals to make payments to physicians have come under close scrutiny from both the Office of the Inspector General (OIG) of the U.S. Department of Health and Human Services (HHS) and the Internal Revenue Service (IRS).

.17 In order to prevent misuses of Medicare and Medicaid funds, Congress enacted the Medicare/Medicaid Anti-fraud and Abuse statute, which forbids the use of Medicare or Medicaid funds to make kickback payments to physicians for referrals or admissions. Because the law was drafted very broadly, it could be interpreted to cover many common commercial arrangements between hospitals and physicians. In order to clarify its intentions in enforcing the law, the HHS OIG has specified eleven payment practices that, though potentially capable of inducing Medicare or Medicaid business, will be protected from criminal prosecution under the statute. Information on these safe harbors can be found in the July 29, 1991, *Federal Register* (56 F.R. 35951). Both the OIG and Congress have shown a strong interest in pursuing Medicare and Medicaid fraud and abuse violations following publication of the safe harbors.

.18 The OIG has also issued a Management Advisory Report, *Financial Arrangements Between Hospitals and Hospital-Based Physicians,* that identifies potential violations of the antikickback statute. Among others, the following common practices are cited as being suggestive of potentially illegal activities:

- Allowing the use of free or significantly discounted office space or equipment in facilities close to the hospital
- Providing free or significantly discounted staff services such as nursing or billing
- Guaranteeing that a hospital will supplement a physician's income up to a certain amount
- Providing loan arrangements that are low-rate, interest-free, or that may be forgiven if referrals are made to the hospital

.19 Another OIG publication, entitled *Fraud Alert on Joint Ventures,* identifies characteristics of hospital-physician joint venture relationships that may provoke questions.

.20 SAS No. 54, *Illegal Acts by Clients* (AU section 317), notes that even though an audit in accordance with generally accepted auditing standards (GAAS) does not include procedures specifically designed to detect illegal acts, procedures applied for the purpose of forming an opinion on the financial statements may bring possible illegal acts to the auditor's attention. SAS No. 54 (AU section 317) also provides guidance on procedures the auditor should perform in response to possible illegal acts.

.21 The interest of the IRS in hospital-physician relationships has centered on whether certain arrangements between tax-exempt hospitals and members of their medical staffs result in private inurement. A decision that private inurement is taking place may result in revocation of the tax-exempt status of the hospital.

Medicare Developments

.22 *Proposed Medicare Budget.* President Clinton's budget for the federal fiscal year beginning October 1, 1993, includes measures designed to reduce Medicare spending. The cuts may affect virtually all providers that participate in the Medicare program. The cuts are only part of the major revisions that are expected to be part of the administration's health care reforms. Changes in Medicare rates and reimbursement policies that are eventually enacted as part of the budget may have significant ramifications for the health care industry. Auditors should be alert to information concerning changes in the Medicare program and should consider the implications of such changes on audit risk. In particular, auditors should consider matters such as whether accounting estimates are based on current rates and information, and whether the strategies being developed by clients to address the changes have accounting or audit implications.

.23 *Prospective Payment System (PPS) Changes.* Changes in the Medicare PPS may affect recorded revenues, receivables, and deferred amounts recorded to account for Medicare and Medicaid timing differences. The May 26, 1993, *Federal Register* includes changes for fiscal year 1994 Medicare PPS (58 F.R. 30222) proposed by the Health Care Financing Administration (HCFA). The proposed changes include provisions on PPS rates, ICD-9-CM coding, disproportionate share payments, capital payment rates, wage indices, outlier payments, rural referral status, and other matters. In the proposed regulations, HCFA recommends PPS rate increases for inpatient operating costs of 4.2 percent for urban hospitals, 5.7 percent for hospitals in rural areas, and 4.3 percent for PPS-exempt hospitals and units for fiscal 1994. Final rules are expected to be released on or around September 1, 1993. The rule revisions are expected to take effect on October 1, 1993, except for the payment rate increases which would take effect on January 1, 1994.

.24 *Geographic Reclassification.* The Medicare PPS rates differ for hospitals in different locations. HCFA has established certain criteria to determine which hospitals are eligible for higher rates because of their location and periodically permits geographic reclassification to alter the classification of service providers as their circumstances change. For fiscal 1994 and thereafter, HCFA has tightened the eligibility criteria for geographic reclassification to exclude approximately 70 percent of the hospitals previously reclassified for wage index purposes. Rule changes published in the September 1, 1992, *Federal Register* provide that hospitals applying for wage index reclassification must pay an average hourly wage rate of at least 108 percent of the area average wage rate and at least 84 percent of the average hourly wage rate for the area to which they seek to be reclassified. These rule changes may result in reduced payments in future periods and may affect future marginal debt-service calculations.

IRS Developments

.25 *Tax-Exempt Status Challenges.* Both the IRS and Congress continue to scrutinize the tax-exempt status of not-for-profit providers. At the same time, mounting budget deficits are causing some states and municipalities to view not-for-profit providers as an untapped source of property and other tax revenues such as sales tax, use tax, and user fees.

.26 The failure by a tax-exempt provider of health care services to maintain its tax-exempt status by complying with relevant tax laws and regulations would have a significant effect on its financial statements. Such a failure could create contingent liabilities that may need to be recorded or disclosed in the financial statements. Thus, auditors should be alert for activities or transactions that could threaten the tax-exempt status of such providers.

.27 *Specific Taxation Issues.* Auditors should focus on the following issues when reviewing the income tax provisions recorded by for-profit health care providers:

- The use of the nonaccrual experience method of accounting to avoid the recognition of income from the performance of services that experience shows will not be collected
- Contractual allowance accounts that represent differences between receivables based on cost reports filed with third-party payors and the amount the entity records for financial statement purposes. (Such differences are being challenged by the IRS as representing taxable income.)
- The scrutiny of for-profit HMOs determine whether they qualify as insurance companies; if so, they may deduct reserves for claims incurred but not reported and defer advanced premiums
- Use of the cash basis by some health care providers other than hospitals
- Recording amortization of intangibles, such as medical records and certificates of need. (Such assets are being questioned as nonamortizable assets.)

Issues such as these can have a significant effect on the income tax provisions and liabilities recorded in the financial statements of health care providers and, therefore, require close scrutiny by auditors.

Guidance for Audits of Entities That Receive Federal Government Funds

.28 Office of Management and Budget (OMB) Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions,* was issued to implement a single audit requirement for not-for-profit organizations. The audit requirements set forth in the circular are applicable for fiscal years beginning on or after January 1, 1990. Institutions covered by OMB Circular A-133 include colleges and universities and their *affiliated hospitals,* as well as other not-for-profit providers of health care services that receive certain funding from federal government agencies. This does not apply to funds received under the Medicare and Medicaid programs.

.29 OMB Circular A-133 audits are required to be conducted in accordance with requirements set forth in the 1988 revision of the *Government Auditing Standards* (often referred to as the Yellow Book), issued by the Comptroller General of the United States, as well as GAAS. The Yellow Book includes general standards, such as requirements that certain engagement personnel meet specified continuing professional education (CPE) requirements and that auditors participate in external quality review programs.

.30 In May 1992, the President's Council on Integrity and Efficiency (PCIE) Standards Subcommittee issued PCIE Position Statement No. 6, *Questions and Answers on OMB Circular A-133.* The Statement provides clarifications and practical guidance on audits conducted in accordance with OMB Circular A-133. Among other things, the statement defines the term *hospital* for purposes of applying the circular, specifies the circumstances under which Medicaid funds should be included in OMB Circular A-133 audits, and clarifies the guidance for determining when hospitals are "affiliated with an institution of higher education." PCIE Statement No. 6 can be obtained from the Superintendent of Documents, U.S. Government Printing Office, P.O. Box 371954, Pittsburgh, PA 15250-7954; telephone number (202) 783-3238, FAX number (202) 512-2250. The stock number is 041-001-00374-6 and the price is $4.50.

.31 The PCIE also issues statistics concerning the results of Federal Inspectors General (IG) desk reviews and quality control reviews of audits of federal activities performed by independent public accountants. The statistics derived from reviews in the past have raised significant concerns about the quality of OMB Circular A-133 audit reports. During a recent six-month period, 43 percent of the OMB Circular A-133 audit reports that underwent desk reviews and 77 percent of the reports that underwent quality control reviews were determined to require major revision or to be significantly inadequate. Statistics for the six months ended September 30, 1992, while incomplete at this time, indicate no improvement.

.32 Some of the most frequently encountered deficiencies include the following:

- Incomplete auditor's reports; internal control or compliance reports that were missing or did not include all required information, such as support for findings or the auditee's comments on the status of prior findings
- Inadequate financial statement disclosures
- Inadequate evidential matter
- Inadequate documentation of substantive testing of compliance with laws and regulations
- Noncompliance with the Yellow Book. Common instances of noncompliance include failure to adequately test internal controls or compliance with laws and regulations and failure to report all findings.
- Failure to document the audit plan or audit program in the working papers.

.33 In December 1992, the AICPA's Auditing Standards Division issued Statement of Position (SOP) 92-9, *Audits of Not-for-Profit Organizations Receiving Federal Awards.* The purpose of the SOP is to provide auditors of not-for-profit organizations with a basic understanding of the work they should do and the reports they should issue for audits performed in accordance with (1) the Yellow Book and (2) OMB Circular A-133.

.34 SOP 92-9 provides guidance on financial and compliance auditing requirements and requirements to consider the internal control structure promulgated by the AICPA, the General Accounting Office (GAO), and the OMB, as well as the application of such requirements to not-for-profit organizations. The SOP, instead of establishing new requirements, consolidates the applicable auditing requirements established by these organizations in order to facilitate efficient and effective compliance. The SOP amends the AICPA Audit and Accounting Guide *Audits of Providers of Health Care Services* and other guides that relate to not-for-profit organizations.

.35 The SOP incorporates the guidance in the following pronouncements:

- SAS No. 68, *Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance* (AU section 801)
- AICPA SOP 92-7, *Audits of State and Local Governmental Entities Receiving Federal Financial Assistance*
- The OMB's 1991 *Compliance Supplement for Audits of Institutions of Higher Learning and Other Non-Profit Institutions*
- The PCIE Standards Subcommittee's Position Statement No. 6

Compliance With Debt Covenants

.36 Many providers' debt-coverage indicators have continued to show unfavorable trends as their operating profits have eroded. Increasing reliance on long-term debt, lower debt service coverage ratios, and weakening financial performance may signal potential problems for many institutions. Such circumstances may cause some providers to fail to comply with debt covenants. Consequently, some lenders may exercise demand clauses, decline to waive covenant violations, or refuse to renew short-term borrowings or letters of credit. In such circumstances, auditors should consider the provider's classification of its liabilities, the adequacy of financial statement disclosures, and management's plans for obtaining adequate alternate financing or disposing of assets. Accounting standards relevant to such issues include Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 6, *Classification of Short-Term Obligations Expected to Be Refinanced* (AC B05), FASB Technical Bulletin No. 79-3, *Subjective Acceleration Clauses in Long-Term Debt Agreements* (AC B05), and EITF Topic No. D-23, *Subjective Acceleration Clauses and Debt Classification.*

SAS No. 70—Service Bureaus

.37 Providers of health care services frequently rely on third parties to process financial information, such as trustee-held bond funds and payroll processing, on their behalf. In April 1992, the AICPA's Auditing Standards Board issued SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AU section 324), which supersedes SAS No. 44, *Special-Purpose Reports on Internal Accounting Control at Service Organizations,* and provides guidance to auditors of entities that use a service organization in connection with the processing of transactions. SAS No. 70 (AU section 324) is effective for service auditors' reports dated after March 31, 1993.

Receivables From Insurance Companies

.38 Providers of health care services often have significant receivables from insurance companies that provide health insurance coverage to their patients. In addition, guaranteed investment contracts with insurance companies have become a popular means of investing crossover debt proceeds. In light of the above, the financial difficulties being experienced by many insurance companies may have a significant impact on health care providers with which they do business. In evaluating audit risk relating to these factors, auditors should consider whether management has procedures for selecting and monitoring insurers. Auditors should also consider obtaining appropriate information about the financial stability of insurers from which significant amounts are receivable. The department of insurance in the state in which the insurance company is domiciled (or in the case of separate operating subsidiaries, the state in which the entity is operating) may be able to identify insurance companies that are experiencing financial difficulties. Other sources available to assist in the evaluation of insurance companies include Best's Insurance Reports (908-439-2200), Veribanc (800-442-2657), Standard & Poor's Rating Department (212-208-1527), and Moody's Investor Service (212-553-0533).

Letters for Underwriters

.39 Health care providers often issue debt securities, many of which provide tax-exempt income to holders, as a primary means of raising capital. SAS No. 72, *Letters for Underwriters and Certain Other Requesting Parties* (AU section 634), provides guidance to independent accountants for performing and reporting on the results of engagements to issue letters for underwriters and certain other requesting parties (commonly referred to as *comfort letters*), in connection with financial statements or financial statement schedules contained in registration statements filed with the Securities and Exchange Commission (SEC) under the Securities Act of 1933 (the Act) and other securities offerings. Historically, independent accountants have provided comfort letters to underwriters in connection with securities offerings registered under the Act. SAS No. 72 (AU section 634) expands the availability of comfort letters beyond those underwriters to include (1) broker/dealers or other financial intermediaries in connection with the offering or placement of securities, and (2) buyers and sellers in connection with an acquisition as long as an exchange of stock is involved. These parties are required to provide the independent accountant with a letter making certain representations as described in SAS No. 72 (AU section 634). If a party requesting a comfort letter is unable to provide those representations, the accountant may not provide them with a comfort letter, but may provide them with other services, such as a review of interim financial information performed in accordance with SAS No. 71, *Interim Financial Information* (AU section 722), or the application of agreed-upon procedures as described in SAS No. 35, *Special Reports—Applying Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement* (AU section 622). The Statement also requires the accountant to perform the review procedures described in SAS No. 71 (AU section 722) when providing negative assurance on interim financial information in a comfort letter.

.40 SAS No. 72 (AU section 634) supersedes SAS No. 49, *Letters for Underwriters*, and is effective for comfort letters issued on or after June 30, 1993.

Risk Concentrating by Physician Groups

.41 Both multispecialty and family-practice physician groups frequently enter into managed-care contracts with HMOs that obligate them to perform all physician services for a specific number of enrolled patients at a fixed capitation rate. In entering into such arrangements, the groups assume the obligation to contract and pay for any services that they themselves are unable to perform. Such contracts may also be subject to shared-risk arrangements in which the groups share in savings or are obliged to pay for cost overages that deviate from those actuarially predicted for enrolled subscribers. The risks assumed by groups in these arrangements may be subject to individual or aggregate stop-loss arrangements.

.42 SOP 89-5, *Financial Accounting and Reporting by Providers of Prepaid Health Care Services*, discusses risk contracting and is included as an appendix to the AICPA Audit and Accounting Guide *Audits of Providers of Health Care Services*. Since physician groups frequently maintain their records using the cash or other comprehensive basis of accounting, their accounting records may fail to include material liabilities for covered services provided outside of the group, such as for services rendered by referral physicians that occurred but were not paid during the accounting period. Auditors of health care providers that participate in arrangements of this nature should carefully consider whether the accounting principles prescribed by SOP 89-5 are being applied. Auditors may find the guidance in SAS No. 57, *Auditing Accounting Estimates* (AU section 342), useful in auditing the accounting estimates that relate to participation in such arrangements.

Related Parties

.43 Certain relationships between health care providers and other entities or persons with whom they transact business may result in the creation of related parties as defined in FASB Statement No. 57, *Related Party Disclosures* (AC R36). As described in earlier sections of this Audit Risk Alert, participation in certain transactions with such parties may threaten the tax-exempt status and Medicare qualification of some providers. For that reason, the risk associated with management's assertions about related party transactions is often assessed as higher than that for many other types of transactions in the health care industry.

.44 Determining the existence of related parties and identifying transactions with them requires the application of specific procedures. Guidance concerning such procedures is contained in SAS No. 45, *Omnibus Statement on Auditing Standards—1983*, "Related Parties" (AU section 334). When auditing identifies related party transactions, auditors should be particularly cognizant that the substance of such transactions may be significantly different from their form and that the financial statements should recognize the substance of a particular transaction rather than merely its form.

.45 Auditors should also consider Auditing Interpretation No. 6 of SAS No. 45, "The Nature and Extent of Auditing Procedures for Examining Related Party Transactions," (AU section 9334.19), which states that when assessing the audit risk associated with related party transactions, auditors should understand the business purpose of the transactions. In fact, until they understand the business sense of related party transactions, auditors cannot consider their audits complete. Auditors should also consider whether the provisions of FASB Statement No. 5, *Accounting for Contingencies* (AC C59), relating to the collectibility of receivables from related or affiliated parties have been properly applied.

Requests for Working Papers by Medicare Auditors

.46 Auditors working for or engaged by Medicare fiscal intermediaries to audit providers' Medicare and Medicaid cost reports frequently request specific independent auditor working paper analyses that "contain data that should properly be reflected in the providers' books and records in order to make such records complete" (*Provider Reimbursement Manual,* Part II, section 1102.3). Recently, some Medicare auditors have requested access to other working papers prepared by independent auditors as well. Although requests by Medicare auditors for access to working papers that contain information that should properly be included in the provider's books and records to make them complete are appropriate, independent auditors are not required to provide access to other working papers. Auditors should carefully consider whether access to other working papers should be granted based on the facts and circumstances surrounding each request. Further guidance on such issues can be found in a *Notice to Practitioners, Guidance for Independent Auditors When Required to Provide Access to or Photocopies of Workpapers to Regulators,* published in the July/August 1993 issue of the *CPA Letter.*

Accounting Issues and Developments

Implementation of SOP 90-8

.47 SOP 90-8, *Financial Accounting and Reporting by Continuing Care Retirement Communities,* requires that such facilities estimate and accrue a liability for their obligation to provide future services. The accrual of such a liability has produced concerns for a number of continuing care retirement communities (CCRCs), particularly those that do not have sufficient assets to satisfy their obligations. In an effort to generate additional revenues to fund the obligation, CCRCs are adopting different strategies. Some are increasing their fees at rates that exceed increases in costs. Others are modifying standard resident agreements. Such strategies may have a number of implications. Fee increases may affect the competitiveness of CCRCs within their markets. Fee increases may also force residents who cannot afford to pay them to withdraw, increasing resident turnover and leaving temporary vacancies. Tax-exempt CCRCs may be required to continue to provide services to residents who cannot afford to pay the higher rates. Modifications to resident agreements are not likely to have any immediate effect on the unfunded obligation for future services, but rather will affect the obligation over time as existing residents are replaced by those who are covered by the new agreements.

.48 Auditors should consider whether assumptions used to determine the amount of the obligation for future services that is accrued are reasonable and whether those assumptions are revised appropriately as conditions change. If it appears that a CCRC may not be able to meet its obligation to provide future services, auditors should also consider the provisions of SAS No. 59 (AU section 341), which requires auditors to evaluate, based on the results of audit procedures performed, whether there is substantial doubt about the entity's ability to continue as a going concern.

New Authoritative Pronouncements

.49 *FASB Statement No. 116,* Accounting for Contributions Received and Contributions Made (AC C67). FASB Statement No. 116 (AC C67) establishes accounting standards for contributions and applies to all entities that receive or make contributions. Generally, contributions received, including unconditional promises to give, are to be recognized as revenues in the period received at their fair values. Contributions made, including unconditional promises to give, are to be recognized as expenses in the period made at their fair values. Conditional promises to give, whether received or made, are to be recognized when they become unconditional, that is, when the conditions are substantially met. The Statement allows certain exceptions for contributions of services and works of art, historical treasures, and similar assets, but requires certain disclosures for receipts of contributed services and promises to give.

.50 The Statement also requires not-for-profit organizations to distinguish between contributions received that increase permanently restricted net assets, temporarily restricted net assets, and unrestricted net assets and to recognize the expiration of donor-imposed restrictions in the period in which the restrictions expire.

.51 The Statement is effective for financial statements issued for fiscal years beginning after December 15, 1994, except for not-for-profit organizations with less than $5 million in total assets and less than $1 million in annual expenses. For those organizations, the Statement is effective for fiscal years beginning after December 15, 1995. Earlier application is encouraged. The Statement may be applied either retroactively or by recognizing the cumulative effect of the change in the year of the change. The provisions for recognition of expirations of restrictions may be applied prospectively. The AICPA Health Care Committee is currently developing technical guidance to assist practitioners in the health care industry with the implementation of this Standard.

.52 *FASB Statement No. 117,* Financial Statements of Not-for-Profit Organizations (AC No5). FASB Statement No. 117 (AC No5) establishes standards for general-purpose external financial statements provided by a not-for-profit organization. It requires that those financial statements provide certain basic information that focuses on the entity as a whole and meets the common needs of external users of those statements.

.53 The Statement requires that all not-for-profit organizations, including not-for-profit hospitals and other providers of health care services, provide a statement of financial position, a statement of activities, and a statement of cash flows. It also requires reporting amounts for the organization's total assets, liabilities, and net assets in a statement of financial position; reporting the change in an organization's net assets in a statement of activities; and reporting the change in its cash and cash equivalents in a statement of cash flows.

.54 The Statement also requires classification of an organization's net assets and its revenues, expenses, gains, and losses based on the existence or absence of donor-imposed restrictions. It requires that the amounts for each of the three classes of net assets—permanently restricted, temporarily restricted, and unrestricted—be displayed in a statement of financial condition and that the amounts of change in each of those classes of net assets be displayed in a statement of activities.

.55 The Statement is effective for annual financial statements issued for fiscal years beginning after December 15, 1994, except for organizations with less than $5 million in total assets and less than $1 million in annual expenses. For those organizations, the Statement is effective for fiscal years beginning after December 15, 1995. Earlier application is encouraged. The AICPA Health Care Committee is currently developing technical guidance to assist practitioners in the health care industry with the implementation of this Statement.

.56 *Governmental Accounting Standards Board (GASB) Statement No. 14,* The Financial Reporting Entity. GASB Statement No. 14 establishes standards for defining and reporting on the governmental financial reporting entity; standards for reporting participation in joint ventures; and disclosure requirements regarding the entity's relationships with other entities, including entities that are jointly owned. GASB Statement No. 14 is applicable to the separately issued financial statements of governmental component units, which specifically include governmental health care providers. It should also be applied to such component units when they are included in a governmental reporting entity. The Statement is effective for financial statements for periods beginning after December 15, 1992.

.57 *GASB Statement No. 16,* Accounting for Compensated Absences. GASB Statement No. 16 provides guidance for the measurement of accrued compensated absences liabilities by state and local governmental entities (including governmental health care providers), regardless of the reporting model or fund type used to report the transactions. Compensated absences are absences for which employees will be paid, such as vacation, sick leave, or sabbatical leave. The provisions of the Statement are effective for financial statements for periods beginning after June 15, 1993.

AICPA Audit and Accounting Literature

Audit and Accounting Guide

.58 The AICPA Audit and Accounting Guide *Audits of Providers of Health Care Services* is available through the AICPA's loose-leaf subscription services. In the loose-leaf service, conforming changes (those necessitated by the issuance of new authoritative pronouncements) and other minor changes that do not require due process are incorporated periodically. Paperback editions of the Guides as they appear in the service are printed annually. Copies may be obtained by calling the AICPA Order Department at (800) 862-4272, Dept. #1, and asking for document number 012426.

Health Care Financial Reporting Checklist

.59 The AICPA's Technical Information Service has published a revised version of *Checklists and Illustrative Financial Statements for Health Care Providers*, a nonauthoritative practice aid for preparers or reviewers of financial statements of health care entities. Copies may be obtained by calling the AICPA Order Department at (800) 862-4272, Dept. #1, and asking for document number 008590.

Technical Practice Aids Publication

.60 *Technical Practice Aids* is an AICPA publication that, among other things, contains questions received by the AICPA's Technical Information Service on various subjects and the service's responses to those questions. Section 6400 of *Technical Practice Aids*, which contains questions and answers specifically pertaining to health care entities, was substantially revised in 1992. *Technical Practice Aids* is available both as a subscription service and in hardback form. Ordering information may be obtained from the AICPA Order Department at (800) 862-4272, Dept. #1, and asking for document number 005053.

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.61 This Audit Risk Alert replaces *Health Care Industry Developments—1992.*

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Appendix A

List of Statistical/Trend Publications

The following are publications pertaining to health care industry trends and statistics that may be of interest to auditors of health care entities. The list is not all-inclusive and is presented for information purposes only. It is not to be construed as an endorsement of any of the following publications or organizations.

Hospitals

Center for Healthcare Industry Performance Studies (CHIPS)

- *Almanac of Hospital Financial & Operating Indicators* (formerly HFMA's Financial Report of the Hospital Industry)

Health Care Investment Analysts, Inc. (HCIA)

- *Comparative Performance of U.S. Hospitals: The Sourcebook*
- *Directory of U.S. Hospitals*
- *HCIA Guide to Hospital Performance*

American Hospital Association (AHA)

- *Hospital Statistics*
- *National Hospital Panel Survey Report*

HMOs

Group Health Association of America, Inc. (GHAA)

- *HMO Industry Profile*

Health Care Investment Analysts, Inc. (HCIA)

- *HMO Performance Almanac*

Nursing Homes

Health Care Investment Analysts, Inc. (HCIA)

- *Guide to the Nursing Home Industry*

Physicians

Medical Group Management Association (MGMA)

- *Cost and Production Survey Report*

For further information contact:

American Hospital
Association (AHA)
(800) AHA-2626

Center for Healthcare Industry
Performance Studies (CHIPS)
(800) 859-2447

Group Health Association of
America, Inc. (GHAA)
(202) 778-3200

Health Care Investment
Analysts, Inc. (HCIA)
(410) 576-9600

Medical Group Management
Association (MGMA)
(303) 799-1111

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Appendix B

Information on Authoritative/Regulatory Publications

AICPA publications referred to in this audit risk alert may be obtained from the American Institute of Certified Public Accountants, Harborside Financial Center, 201 Plaza Three, Jersey City, NJ 07311-3811 (or call 800-862-4272).

Federal government publications referred to in this audit risk alert may be obtained from the Superintendent of Documents, U.S. Government Printing Office, P.O. Box 371954, Pittsburgh, PA 15250-7954 (order desk telephone: 202-783-3238; FAX: 202-512-2250).

All statements of the President's Council on Integrity and Efficiency (PCIE), except for PCIE Statement No. 6, can be obtained by writing or faxing the Treasury Office of Inspector General, Room 7210, ICC Building, 1201 Constitution Avenue NW, Washington, DC 20220 (FAX: 202-927-5418). PCIE Statement No. 6 (order number 041-001-00374-6) can be obtained from the U.S. Government Printing Office (see above).

To order individual copies of the Federal Register, send your request to: New Orders, Superintendent of Documents, P.O. Box 371954, Pittsburgh, PA 15250-7954. Specify that you want the *Federal Register* and provide the date of the issue you want, and enclose a check or money order payable to the Superintendent of Documents. Alternatively, you may enclose your Visa or MasterCard number and expiration date. Credit card orders can also be placed by calling the order desk at (202) 783-3238. The cost for each printed copy is $4.50; for microfiche, $1.50 per copy.

Auditors should also be aware of the economic, regulatory, and professional developments that may affect the audits they perform as described in *Audit Risk Alert—1993* [AAM section 8010].

[The next page is 8107.]

AAM Section 8040
Insurance Industry Developments—1993

Industry and Economic Developments

.01 The financial fitness of the insurance industry is currently under intense scrutiny by consumers and regulators. Rising rates for automobile and medical insurance, and concerns about the financial stability of some life insurers, have produced much consumer worry and resentment. Adding to the unrest were the efforts of several home insurers to withdraw from Florida and other hurricane-prone areas.

.02 Property and liability insurers historically have operated in a cyclical environment. Periods of declining industry capacity and rising premium rates and volume are followed by periods in which competition for premium volume and market share drive premium rates down. The property and liability pricing environment has deteriorated steadily since 1986. However, some industry experts have predicted that the record catastrophe losses of 1992 and 1993 would be the catalyst needed to turn the pricing cycle around. Although the underwriting environment has failed to take a decidedly positive turn thus far in 1993, the deterioration in operating ratios appears to have subsided. It now appears to be steady, with only a few lines of business deviating from this pattern. While rate increases should reverse this cycle, some believe that state regulators will not approve the necessary rate increases. In the past, rate increases generally have not been adequate to cover escalating loss costs, and as a result, financial positions have deteriorated. Since some are unable to obtain approval of adequate rate increases, many insurers are reducing their exposure in unprofitable areas or are otherwise selectively writing certain businesses. This has caused concerns among regulators about possible "red-lining" practices by insurance companies.

.03 On the commercial side, little has changed since the end of 1992. Although prices appear to be inching up, some believe that this activity will only be sufficient to offset increases in costs, and the financial results of most commercial underwriters are likely to stay flat through the end of 1993. The most active area of the property and liability sector is reinsurance, a business dominated by a limited number of players. In response to the heavy catastrophic losses over the last few years, property catastrophe coverage has become very scarce, forcing most primary insurers to retain a higher portion of the risk. This imbalance between supply and demand will likely keep reinsurance rates for property coverage moving sharply higher.

.04 In assessing risk in auditing the financial statements of property and liability insurance companies, auditors should consider the lines of insurance that the companies write. The risk characteristics inherent in different lines of insurance vary as widely as the nature of the perils that are insured. For example, factors such as competition, the availability of reinsurance, and state commissioners' approval of premium rates may influence the risk characteristics of different lines. Therefore, auditors should evaluate the audit risks associated with different lines of business separately.

.05 The life and health sector of the industry continues to show solid earnings growth as the economy slowly improves. A general economic rebound could affect life insurers in several ways. These include increased policy sales due to rising employment, more discretionary income invested in tax-deferred instruments through life insurance, greater access to health insurance, and slightly higher interest rates. While insurers handling health insurance have implemented price increases over the past few years, increased health care costs put a strain on company profitability and surplus positions. Many companies are abandoning the marketplace for this type of insurance, and those remaining are implementing more stringent underwriting standards.

.06 The degree of liquidity risk inherent in the operations of insurance companies is an important element in auditors' assessments of audit risk. Liquidity risk refers to the need to have funds available to meet obligations on a timely basis. The need for appropriate matching of assets and liabilities to allow for the payment of benefits when due or demanded by policyholders is an important concern in managing life insurance companies. In assessing audit risk, auditors should consider whether adequate procedures, such as use of cash flow or asset/liability matching models, have been implemented to evaluate the liquidity and ability of insurers to pay benefits when due or demanded.

.07 Asset quality and duration issues also remain a concern for the insurance industry. Depressed real estate conditions across the country have adversely affected investment performance and liquidity. Occupancy rates in commercial buildings remain low as companies continue to downsize, and rental rates remain low due to competitive pressures. Mortgage loan defaults are also continuing with no indication that the worst is over. Additionally, even though defaults on investments in private placements have subsided, insurers should continually monitor their portfolios for potential problems. Overall, in the insurance industry, investment trends indicate that insurance companies have been investing new money in higher-quality, fixed-income investments. Since interest rates remain low, yields on investment portfolios are trending lower. The lower investment yields can have a very significant impact on the net income of life insurers, depending on their ability to reprice interest-sensitive liabilities. The preservation of capital continues to be a key concern for insurance companies.

.08 Auditors should be aware that the recoverability of asset values is a significant area of audit risk and should review management's policies and procedures for determining permanent impairment and reserve requirements in the planning stages of the audit. Auditors should also carefully review management's valuation procedures for any foreclosed or in-substance foreclosed real estate. Private placements and other nonpublicly traded investments should also be carefully evaluated for impairment. Auditors of insurance entities with investments in private placements and other nonpublicly traded investments should consider using the work of a specialist in performing this portion of the audit. AICPA Statement on Auditing Standards (SAS) No. 11, *Using the Work of a Specialist* (AU section 336), provides guidance to auditors who use the work of a specialist in performing the audit of financial statements. (See further discussion of asset impairment in the "Audit Issues" section of this alert.)

Regulatory Developments

Regulatory Risk-Based Capital Requirements for Life Insurance Companies

.09 Regulation of life insurance companies historically has focused on their capital. Beginning with the 1993 Annual Statement, the National Association of Insurance Commissioners (NAIC) is requiring that life insurance companies disclose risk-based capital (RBC) in their statutory filings. The RBC calculation will serve as a benchmark for the regulation of life insurance companies' solvency by state insurance departments. RBC provides dynamic surplus formulas similar to target surplus formulas used by commercial rating agencies. The formulas specify various weighting factors that are applied to financial balances or various levels of activity based on the perceived degree of risk, and are set forth in the RBC requirements. The NAIC has established certain risk-based capital ratios that trigger regulatory action levels.

.10 Because of the importance of RBC to life insurance enterprises, RBC should be considered in assessing risk and planning the audit. The auditor should ordinarily obtain and review the client's RBC reports and should understand the RBC requirements for preparing such reports and the actual regulations associated with RBC.

.11 The AICPA expects to issue a Statement of Position (SOP) entitled *The Auditor's Consideration of Regulatory Risk-Based Capital for Life Insurance Enterprises* (watch for an announcement in the *CPA Letter*) by the end of the year, which will provide auditors with guidance on the consideration of RBC in the planning stage of the audit as well as guidance on auditors' reports. (See also the "Disclosures of Certain Matters in the Financial Statements of Insurance Entities" discussion in the "Accounting Developments" section of this alert [paragraph .77].)

.12 Auditors of property and liability insurers should be alert to the fact that the NAIC is currently in the approval process of similar RBC requirements for property and liability insurance companies.

Noncompliance With Regulatory Requirements

.13 Because insurance companies have a public responsibility to be able to meet their obligations to policyholders, state insurance statutes and regulations prescribe standards and limitations on investment activities. Regulatory requirements and restrictions vary by state. With most states restricting insurance companies from having excessive concentrations in certain classes of investments, auditors should be knowledgeable of these restrictions and perform auditing procedures to determine whether the insurance company is in compliance.

.14 Events of noncompliance with state regulatory requirements, such as failure to meet risk-based capital or investment requirements, expose insurance companies to regulatory action. Events of noncompliance may be brought to an auditor's attention during normal auditing procedures, the review of regulatory examination reports, or as a result of actions required by regulators.

.15 SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU section 341), states that "the auditor has a responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited." Noncompliance or expected noncompliance with regulatory requirements is a condition, when considered with other factors, that could indicate substantial doubt about the insurance company's ability to continue as a going concern for a reasonable period of time.

Audit Issues

Overall Risk Factors

.16 Although conditions vary from company to company, the following are among the conditions that may affect audit risk in the insurance industry:

- Continued widespread competition in product pricing
- Overall increases in claims costs and benefits paid resulting from increases in litigation, the amounts of jury awards or settlements, catastrophes, the rising costs of medical care, and other large losses
- Inadequate liquidity, resulting in insufficient funds to pay claims and benefits when due or demanded by policyholders
- High levels of credit or liquidity risk associated with investments, such as real estate, mortgage loans, junk bonds, credit risks in retro-rated and experience-rated contracts and collateralized mortgage obligations
- The long-tail nature of certain property and liability lines of business, characterized by lags between the occurrence, reporting, and settlement of claims
- Extensive use of estimates, such as those for determining loss reserves or future policy benefits, in the accounting process
- Extensive and complex reinsurance arrangements and doubts about the financial viability of reinsurers
- Reliance on third parties, such as managing general agents, third-party administrators, and brokers
- Changes in levels of risk that insurers are willing to retain (that is, retention amounts)
- Extensive regulatory oversight of the industry and the changing nature of the regulatory environment
- The need to meet capital and surplus requirements imposed by regulatory authorities, and the need for sufficient capital and surplus to support company growth and stability
- The adoption of new risk-based capital requirements, which are effective in 1993 for life/health insurers

Auditors should carefully consider these industry-specific conditions and evaluate the impact these conditions have on audit risk.

Specific Conditions or Risk Factors

.17 This section describes conditions that may vary from company to company and may indicate (but not necessarily confirm) the existence of increased audit risk.

.18 *Ineffective Management and Internal Controls.* The highly competitive environment of the insurance industry is forcing many insurers to become more efficient. To increase efficiency, some insurers have reduced their staff; however, the demands of operating and reporting functions often have increased, or have remained constant. As a result, the internal control structure on the whole may become less effective. Lack of a formal management policy in administering and monitoring operations also may decrease the effectiveness of the internal control structure and affect the auditor's assessment of audit risk. Management's policies and controls over establishing adequate pricing of products, establishing loss reserves, asset/liability matching, and use of reinsurers are also important considerations in assessing and controlling audit risk for insurance companies.

.19 SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AU section 319), provides guidance on the independent auditor's consideration of an insurance company's internal control structure in an audit of financial statements in accordance with generally accepted auditing standards (GAAS). It describes the elements of an internal control structure and explains how an auditor should consider the internal control structure in planning and performing an audit.

.20 *Use of Accounting Estimates.* Insurance companies rely heavily on the use of estimates in the preparation of financial statements. Estimates of loss reserves are generally of particular significance to the financial statements of insurers. SAS No. 57, *Auditing Accounting Estimates* (AU section 342), provides guidance to auditors on obtaining and evaluating sufficient, competent evidential matter to support significant accounting estimates in an audit of financial statements in accordance with GAAS. SOP 92-4, *Auditing Insurance Entities' Loss Reserves,* provides guidance to help auditors understand the loss reserving process and to develop an effective audit approach when auditing loss reserves of insurance entities.

.21 Because the process of estimating loss reserves is complex and involves many subjective judgments, the absence of involvement by a loss reserve specialist in the determination of management's estimates may constitute a reportable condition and possibly a material weakness in the insurance company's internal control structure. SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* (AU section 325), describes the auditor's responsibility to communicate reportable conditions to the audit committee or other individuals with equivalent responsibility.

.22 *Participation in Involuntary Pools and Markets.* Property and liability insurers often have significant exposure to loss development from previously reported results of various involuntary pools in which they participate, such as that experienced in 1991 and 1992 in the National Workers' Compensation Pool. Auditors should consider insurers' exposure to fund deficits of such pools in assessing audit risk and accruals. In addition, under state regulations, insurers are required to participate in mandatory pools and associations for insurance insolvencies, that is, guaranty funds. Auditors should be aware that, for certain state pools, insolvencies of major carriers may cause additional assessments to the surviving carriers. Auditors should consider management's assertions about the sufficiency of accruals and disclosures relating to participation in involuntary pools, mandatory pools and guaranty funds in accordance with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (AC C59).

.23 *Surplus Enhancement.* Insurance companies sometimes engage in transactions to improve their statutory financial position. These transactions are commonly referred to as surplus enhancement transactions. Regulators and legislators scrutinize such transactions closely. As they assess audit risk, auditors should be alert for transactions (1) that result in a material adjustment of statutory income or surplus or (2) that affect the statutory-basis financial statements in a manner that is substantially different from the effect on statements prepared in conformity with generally accepted accounting principles. Cognizance of such transactions is especially important when an insurer's surplus is at or near statutory minimum levels. In evaluating the propriety of the accounting treatment accorded to such transactions or the related adjustments to the statutory surplus, the auditor should consider the insurer's correspondence with state insurance departments and documentation of compliance with applicable insurance laws or regulations.

.24 An insurance enterprise's ability to continue to receive permission from the state insurance department is not guaranteed. In such circumstances, Securities and Exchange Commission (SEC) registrants should be reminded of the requirements of Item 303 of Regulation S-K, which requires disclosure of the reasonably likely effects of such uncertainties. For example, NAIC rules adopted in 1992 for life insurance companies require a phase out of reserve credits for certain reinsurance transactions. Uncertainties regarding *permitted* statutory accounting for certain transactions (for example, reinsurance) should be disclosed in the financial statements in accordance with paragraph 60 of FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises* (AC sections I42.129 and In6.166), so that the disclosures regarding the "effects of statutory accounting practices" are not misleading to the financial statement readers.

.25 *Prescribed or Permitted Transactions Under Statutory Accounting Practices.* Statutory Accounting Practices (SAP) consist of certain sources such as insurance laws, regulations, administrative rulings, and NAIC publications as well as accounting practices that are prescribed or permitted by an insurer's domiciliary insurance department and, in some instances, by the insurance departments of other states in which the insurer is authorized to do business. Insurance companies preparing SAP financial statements may adopt an accounting treatment that is not prescribed by the state of domicile or supported by other recognized sources of prescribed statutory accounting practices. In that situation, the insurer is required to have permission from the domiciliary insurance department, hence the term *permitted.* Accordingly, when an insurance company applies a statutory accounting practice that is material to its financial statements, and in the auditor's judgment is not a *prescribed* statutory accounting practice, the auditor should consider annually obtaining sufficient competent evidential matter to corroborate management's assertion that such accounting treatment is *permitted* by the domiciliary state insurance department. Written positive acknowledgment from the insurance department, and direct meetings with the regulators supported by appropriate written memoranda, are considered sufficient competent evidential matter for this purpose.

.26 In accordance with SAS No. 58, *Reports on Audited Financial Statements* (AU section 508), if the auditor is unable to obtain sufficient competent evidential matter to corroborate management's assertion regarding a *permitted* statutory accounting practice which is material to the financial statements, the auditor should consider qualification or disclaimer of an opinion on the statutory financial statements due to a limitation on the scope of the audit.

.27 The AICPA expects to issue an SOP entitled *Inquiries of Representatives of State Insurance Regulators* by the end of the year (watch for an announcement in the *CPA Letter*). This SOP will require auditors to annually obtain sufficient competent evidential matter to corroborate management's assertion that an accounting treatment is *permitted* by the domiciliary state regulators. This SOP will apply to audits of statutory financial statements for periods ending on or after December 15, 1994.

.28 *Unsound Pricing and Underwriting Practices.* When determining premium rates, widespread competition in the insurance industry often leads to increased emphasis on competitors' rates. In such circumstances, premium determinations may be made without considering differences in the insured risks. Sound pricing decisions require consideration of appropriate information and reasonable estimates of expected losses and expenses. A lack of established pricing policies may lead to the acceptance of unanticipated risks or the inappropriate pricing of those risks, which could result in concerns about the recoverability of deferred acquisition costs and premium deficiencies. Auditors should evaluate the audit risk associated with unsound pricing and underwriting practices.

.29 *Asset Quality and Valuation Issues.* Credit quality and other asset quality issues associated with loans, real estate portfolios, troubled debt restructurings, foreclosures and in-substance foreclosures, off-balance-sheet financial instruments, and other assets require critical attention in audits of the financial statements of insurers. Auditors should obtain reasonable assurance that management has recorded adequate asset valuation allowances and liabilities for other credit exposures based on all relevant factors. The subjectivity of determining asset valuation allowances, combined with continued economic uncertainty, reinforces the need for careful planning and execution of audit procedures in this area.

.30 Lack of an asset impairment evaluation system or failure of an insurer to document adequately its criteria and methods for determining asset valuation allowances may indicate a material weakness in the insurer's internal control structure and will generally increase the extent of judgment that must be applied by both regulatory examiners and auditors in evaluating the adequacy of management's allowances and will increase the likelihood that differences will result. The guidance in SAS No. 57 (AU section 342) should be followed in auditing asset valuation allowances. Other sources of information on auditing loan loss allowances include the AICPA Audit and Accounting Guides *Audits of Savings Institutions* and *Audits of Credit Unions*, the Industry Audit Guide *Audits of Banks*, and the Auditing Procedure Study *Auditing the Allowance for Credit Losses of Banks*. The Audit and Accounting Guide *Guide for the Use of Real Estate Appraisal Information* provides guidance to help auditors understand real estate appraisal concepts and information.

.31 As with credit risk, other valuation issues involve many subjective assumptions. For example, the expected effects of prepayments on loans in portfolios and the types of income and expense items included in valuations of loan servicing assets have a significant impact on the recorded values of those assets. High levels of prepayments of mortgage loans, for example, have resulted in impairment of many assets, such as purchased mortgage servicing receivables and interest-only securities. Evaluation and recognition of impairment due to prepayments should include consideration of the insurer's aggregation policy, discount rates, and assumptions about the future prepayment rates.

.32 Further, falling interest rates have created an environment in which transactions involving gains trading of securities, refinancing of loans, restructuring of nonperforming assets, origination of loans to facilitate the sale of real estate owned, and other asset dispositions all require specific attention. Such transactions require an understanding of the specific situations so that the auditor may carefully assess and control audit risk.

.33 *Derivatives and Other High-Risk Investments.* In recent years there has been a growing use of innovative financial instruments that often are very complex and can involve a substantial risk of loss. Users and issuers of such instruments must have the expertise necessary to understand and manage the related risks. As discussed below, auditors should also be familiar with such instruments and the associated risks. One class of these instruments—derivatives—requires particular attention.

.34 Derivatives are complex financial instruments whose values depend on the values of one or more underlying assets or financial indexes. Derivatives generally fall into at least two categories:

- Asset-backed securities, which include mortgage-backed securities, interest-only and principal-only strips, and tranches of collateralized mortgage obligations
- Off-balance-sheet instruments such as forward contracts, interest-rate and currency swaps, futures, options and other financial contracts

By reconfiguring cash flows associated with underlying assets, an issuer can create asset-backed securities that meet the needs of and are attractive to various potential users by isolating, enhancing, or diluting one or more of credit, liquidity, interest-rate, and other risks inherent in the underlying cash flows. For example, through mortgage-backed securities, the issuer can enhance the marketability of underlying mortgage loans by spreading liquidity and credit risk across broad pools, or by providing a higher yield to those users willing to accept a higher concentration of the risks associated with specific collateral cash flows. Similarly, users find certain derivatives attractive because they can purchase the risks and rewards they desire most, or can synthetically create a security with the desired risk and reward characteristics.

.35 Increased volatility of interest rates, foreign exchange rates, and commodity and other prices has also fostered tremendous innovation in financial products to meet the needs of users attempting to hedge or alter the related risks. Swaps, for example, are financial contracts in which two parties exchange streams of payments over a period of time. An entity with debt that carries variable interest rates (such as an entity that has short-term certificates of deposit) might swap interest rate payments on an agreed-upon principal amount with a counterparty by paying a fixed rate and receiving a variable rate. The entity locks into an interest rate for the term of the swap, reducing the risk that increases in interest rates will increase the entity's cost of funds as its liabilities are refunded or related interest rates are reset. The entity takes on other risks, however, such as the risk that the counterparty could default on its payments. By locking into fixed rates, the entity will no longer benefit from interest rate decreases during the term of the swap and it is often costly to terminate a swap. Further, the fair value of derivatives can be volatile in periods of changing market conditions.

.36 *Accounting.* Accounting for derivatives is complex. Given the constant innovation and complexity of derivatives, accounting literature does not explicitly cover some derivatives; however, several related projects are underway.

.37 The FASB has been carrying out a major project on the recognition and measurement of financial instruments, which has already resulted in the issuance of FASB Statements No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (AC F25), No. 107, *Disclosures about the Fair Values of Financial Instruments* (AC F25), and No. 115, *Accounting for Investments in Certain Debt and Equity Securities* (AC I80), and FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts* (AC B10), that address related issues. The FASB's project includes a comprehensive review of accounting for hedging and risk-adjusting derivatives. Also, the International Accounting Standards Committee is in the process of developing an international accounting standard for financial instruments.

.38 Several accounting issues involving derivatives have also been addressed by the FASB's Emerging Issues Task Force (EITF). Other guidance is provided by FASB Statements No. 52, *Foreign Currency Translation* (AC F60), and No. 80, *Accounting for Futures Contracts* (AC F80). In addition, AICPA Issues Paper No. 86-2, *Accounting for Options,* discusses various matters related to options.

.39 *Auditing.* The innovative and complex nature of such investment vehicles may significantly increase audit risk. For example, as more and more financial institutions enter the markets for such instruments, their profitability may diminish. Traders may attempt to compensate for the diminution by increasing the volume of transactions involving such instruments or by further customizing products. An increase in volume may be accompanied by trading with counterparties that have higher credit risk. Customizing transactions may increase valuation difficulties. The propriety of the methods used by the managements of insurance companies to account for transactions involving sophisticated financial instruments and to determine their value should be carefully considered. Understanding the substance of transactions in such instruments is important in determining the propriety of their accounting treatment. In some circumstances, auditors may find it helpful to consult with experts.

.40 SAS No. 22, *Planning and Supervision* (AU section 311), requires that auditors understand the events, transactions, and practices that, in their judgment, may have a significant effect on the financial statements. Accordingly, auditors should carefully consider the various risks involved with investments in derivatives and other complex securities as they plan their audits and should—

1. Assess management's expertise in monitoring, evaluating, and accounting for the securities.

2. Ensure that the entity has set appropriate policies and procedures for investment in high-risk securities and that there is adequate oversight by the board of directors.

3. Involve specialists, when necessary, in valuing and auditing these investments.

.41 *Significant Real Estate Holdings.* Some insurance companies (particularly life insurers) may have significant owned or leased real estate or may provide financing under real estate collateralized obligations. Because of the weak real estate market, certain current values are significantly lower than those even as recent as six months to a year ago. One of the contributing factors to the rapid decline in values is the emergence of substantial real estate portfolios available for sale. Insurance companies that have provided real estate financing may not have considered the full impact of these value declines. Even recent independent appraisals may have failed to fully reflect current market conditions as the appraisal may be based in part on specific assumptions stipulated by the company ordering the appraisal. Real estate, although traditionally considered a long-term investment, is currently even less liquid than in prior years, because of excess supply and limited credit availability.

.42 The following are some conditions which may indicate a need for auditors to further consider the appropriateness of real estate valuations and related disclosures:

- Cash flows from operating activities are insufficient to cover debt service.
- Current occupancy rates indicate that the future cash flows to be received from the investment are lower than the amounts needed to fully recover the investment's carrying amount.
- The lessor is having to make significant concessions in order to rent the property.
- Properties held for sale remain unsold at subsequent balance sheet dates.
- The number of delinquent loans or repossessed properties has increased.
- The value of the real estate that collateralized nonrecourse mortgage loans has declined.
- Other investors have decided to cease providing support or to reduce their financial commitment to the real estate project or venture.
- The previous year's auditor's report contains an explanatory or emphasis paragraph relating to real estate investments.

When circumstances such as these are present, auditors should consider the need for appropriate write-downs or reserves and the impact on any disclosures required by or presented voluntarily in accordance with FASB Statement No. 107 (AC F25). Interpretation No. 1, "Performance and Reporting Guidance Related to Fair Value Disclosures," of SAS No. 57 (AU section 9342) was issued in February 1993 to provide auditors performance and reporting guidance related to fair-value disclosures.

.43 Auditors should also consider whether real estate held for investment is reported at cost less accumulated depreciation. If it appears that an investment in real estate may be sold, or the insurance company cannot demonstrate the ability to hold the real estate indefinitely, or the property is classified as in-substance foreclosed in accordance with AICPA Practice Bulletin No. 7, *Criteria for Determining Whether Collateral for a Loan Has Been In-Substance Foreclosed,* then the auditor should consider whether the accounting principles applicable to real estate held for sale are being followed. Real estate held for sale, other than foreclosed real estate held for sale (which should be accounted for in accordance with SOP 92-3, *Accounting for Foreclosed Assets*), should be carried at the lower of cost or estimated net realizable value using a valuation account to reflect declines in net realizable value from the carrying value on an individual property basis, in accordance with FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects* (AC Re2).

.44 *Reinsurance Arrangements.* Reinsurance arrangements can be complex and reinsurance contracts can be complicated. Adequate control over a company's reinsurance program requires that management have knowledge and understanding of the reinsurance business and the financial effects of reinsurance. The lack of an adequate reinsurance program may expose an insurance company to risks that can jeopardize its financial stability, particularly if its risks are concentrated by type or geographic area. In contrast, excessive reinsurance coverage can significantly reduce the margins available to cover fixed and overhead expenses. Auditors should obtain an understanding of the reinsurance programs of the insurance entities that they audit. Significant changes in an insurer's reinsurance programs or retention limits may be relevant to the auditor's assessment of audit risk related to estimates of loss reserves or reinsurance recoverable. Auditors should also consider whether management has established policies for selecting reinsurers and monitoring reinsurers' ability to pay reinsurance claims when they come due.

.45 Because of recent catastrophic events, insurers are using reinstatement reinsurance to reduce exposures. Auditors should evaluate whether layers of reinsurance programs have been pierced and whether additional premiums for reinstatement reinsurance have been properly reported.

.46 The collectibility of amounts due under ceded reinsurance arrangements continues to be of concern to the insurance industry. Collectibility problems may arise if the assuming company becomes financially unsound or if there is a dispute concerning coverage. The AICPA Audit and Accounting Guide *Audits of Property and Liability Insurance Companies* discusses the controls or procedures that ceding companies should implement to evaluate the financial stability of assuming companies. Collectibility concerns can also arise when assuming companies challenge or repudiate reinsurance claims based on disagreements over interpretations of contract terms or allegations that a ceding company has not fulfilled its contractual obligations.

.47 Assumed reinsurance may be difficult to underwrite because the coverage is often unique. Accordingly, some companies, particularly those that only occasionally assume reinsurance, may not have sufficient experience to manage such business or may not have adequate procedures to evaluate underwriting standards, or to monitor the business. In addition, assuming companies may experience significant delays in receiving information from ceding companies, intermediaries, retrocessionaires, or other parties to the contracts, which may result in delays in notification of amounts of written premiums or losses incurred under contracts, or a lack of supporting information needed for financial reporting and administration of the business.

.48 Further guidance on auditing reinsurance arrangements is provided in the AICPA Audit and Accounting Guide *Audits of Property and Liability Insurance Companies* and in the SOPs *Auditing Property and Liability Reinsurance* (originally issued in 1982) and *Auditing Life Reinsurance* (originally issued in 1984). Accounting issues and developments concerning reinsurance arrangements are discussed in detail in the "Accounting Developments" section of this alert.

.49 *Related-Party Transactions.* Certain related-party transactions are currently receiving a great deal of public and regulatory scrutiny. These transactions include—

- Loans to insurance companies' officers and directors or their affiliates.
- Fees or commissions paid to officers and directors or their affiliates.
- Other arrangements, including purchased goods or services from and contracts with officers and directors or their affiliates.

SAS No. 45, *Omnibus Statement on Auditing Standards—1983* (AU section 334), provides guidance on procedures that should be considered by auditors in order to identify related-party relationships and transactions and to satisfy themselves concerning the accounting for and disclosure of transactions with related parties.

Audit Developments

Auditing Property/Casualty Insurance Entities' Statutory Financial Statements—Applying Certain Requirements of the NAIC Annual Statement Instructions

.50 SOP 92-8, *Auditing Property/Casualty Insurance Entities' Statutory Financial Statements—Applying Certain Requirements of the NAIC Annual Statement Instructions,* was issued in October 1992 and provides guidance on the impact of certain requirements of the NAIC's Annual Statement Instructions—Property and Casualty on the auditor's procedures in the audit of statutory financial statements of property and liability insurance entities. SOP 92-8 is effective for audits of statutory-basis financial statements of property and liability insurance entities for periods ending after December 15, 1992.

Accounting Developments

Assumption Reinsurance

.51 Unlike typical reinsurance, assumption reinsurance is intended to extinguish the primary insurer's obligations to the policyholder, and is reported in a manner similar to the disposition of a business rather than as reinsurance. Under assumption arrangements, the primary insurer typically transfers the policies without the prior consent of the policyholders. Auditors should evaluate the insurance company's determination whether a given contract is assumption or novation reinsurance. The determination of whether an involuntary transfer without the prior consent of the policyholder that is the result of an assumption reinsurance contract extinguishes the ceding company's liability to its policyholders is a legal determination. Auditors should confer with legal counsel in their evaluation of the appropriateness of the insurance company's determination. Associated contingencies may require footnote disclosure pursuant to FASB Statement No. 5 (AC C59). If a contract is appropriately determined to be an assumption reinsurance contract, the auditor should consider whether the ceding company has removed the related assets and liabilities from its financial statements since the ceding company no longer has any liability to the policyholder.

Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts

.52 In December 1992, the FASB issued FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts* (AC In6), which specifies the accounting by insurance companies for the reinsuring (ceding) of insurance contracts. It amends FASB Statement No. 60 (AC In6) to eliminate the practice by insurance companies of reporting assets and liabilities relating to reinsured contracts net of the effects of reinsurance. The Statement requires reinsurance receivables (including amounts related to claims incurred but not reported and liabilities for future policy benefits) and prepaid reinsurance premiums to be reported as assets. Estimated reinsurance receivables are recognized in a manner consistent with the liabilities relating to the underlying reinsured contracts.

.53 The Statement establishes the conditions required for a contract with a reinsurer to be accounted for as reinsurance and prescribes accounting and reporting standards for those contracts. The accounting standards depend on whether the contract is long-duration or short-duration and, if short-duration, on whether the contract is prospective or retroactive. For all reinsurance transactions, immediate recognition of gains is precluded unless the ceding company's liability to its policyholder is extinguished. Contracts in which the reinsurer does not assume significant insurance risk or that do not result in the reasonable possibility that the reinsurer may realize a significant loss from the insurance risk assumed generally do not meet the conditions for reinsurance accounting and are to be accounted for as deposits. Determining whether a contract with a reinsurer provides indemnification against loss or liability relating to insurance risk requires a complete understanding of that contract and other contracts or agreements between the ceding enterprise and related reinsurers. A complete understanding includes an evaluation of all contractual features that (1) limit the amount of insurance risk to which the reinsurer is subject or (2) delay the timely reimbursement of claims by the reinsurer.

.54 Auditors should consider whether ceding companies adequately disclose the nature, purpose, and effect of reinsurance transactions, including the premium amounts associated with reinsurance assumed and ceded. Auditors should also consider whether disclosure of concentrations of credit risk associated with reinsurance receivables and prepaid reinsurance premiums is adequate as required by the provisions of FASB Statement No. 105 (AC F25).

.55 Auditors should refer to FASB Viewpoints, "Accounting for Reinsurance," in the February 26, 1993, *FASB Status Report* for additional guidance. Auditors of SEC registrants should be aware that the SEC staff will expect property and liability insurance companies to disclose loss reserve tables on a gross basis, in the year the insurance company adopts FASB Statement No. 113 (AC In6). For periods prior to 1993, the SEC has indicated that restatement to reflect gross amounts is encouraged, but not required. If a registrant elects to restate its financial statements, the restatement of data for all prior periods included in the Guide 6 tables (and the Selected Financial Data presented pursuant to Item 301 of Regulation S-K) will result in the most consistent and useful presentation. However, the SEC will accept an alternative presentation where the registrant's prior reserving practices make restatement for all periods impracticable provided that the reasons for not restating the data in the Guide 6 tables are disclosed.

.56 FASB Statement No. 113 (AC In6) is effective for financial statements for fiscal years beginning after December 15, 1992. Auditors of insurance companies with long-duration and short-duration reinsurance contracts should give the following aspects of the Statement particular consideration:

1. Whether reinsurance contracts are appropriately identified as short-duration or long-duration
2. Whether contracts determined to be short-duration are appropriately identified as either prospective or retroactive reinsurance
3. Whether contracts indemnify the ceding company against loss or liability and therefore meet the conditions for reinsurance accounting
4. If reinsurance contracts are determined to be "assumption reinsurance" contracts as described above, whether all related assets and liabilities are removed from the ceding company's financial statements
5. Whether amounts receivable and payable between the ceding company and an individual insurer should be offset under the requirements of FASB Interpretation No. 39 (AC B10)

Accounting for Funding Cover Arrangements

.57 The FASB's EITF reached a consensus on Issue No. 93-6, *Accounting for Funding Cover Arrangements.* An insurer (ceding enterprise) may enter into a multiple-year retrospectively rated reinsurance contract (RRC) with a reinsurer (assuming enterprise). Examples of these contracts may include transactions referred to as "funded catastrophe covers."

.58 These contracts include a "retrospective rating" provision that provides for at least one of the following based on contract experience: (1) changes in the amount or timing of future contractual cash flows, including premium adjustments, settlement adjustments, or refunds to the ceding enterprise, or (2) changes in the contract's future coverage. A critical distinguishing feature of these contracts is that part or all of the retrospective rating provision is obligatory such that the retrospective rating provision creates future rights and obligations as a result of past events. A retrospectively rated contract that could be canceled by either party without further obligation is not covered by this Issue.

.59 The Task Force reached a consensus that (1) to the extent that the ceding enterprise has an obligation to make payments to the reinsurer that would not have been required absent experience to date under the contract (for example, payments that would not have been required if losses had not been experienced), whether the ceding enterprise should recognize a liability and the assuming enterprise should recognize an asset, (2) to the extent that a ceding enterprise would be entitled to receive a payment from the reinsurer based on experience to date under the contract (for example, the ceding enterprise would receive a payment if no future losses occur), the ceding enterprise should recognize an asset and the assuming enterprise should recognize a liability, and (3) the ceding enterprise and the assuming enterprise should account for changes in coverage in the same manner as changes in the other contract costs—that is, based on past experience under the contract.

.60 The Task Force also reached a consensus that in order to be accounted for as reinsurance, a contract that reinsures risks arising from short-duration insurance contracts must meet all of the following conditions: (1) the contract must qualify as a short-duration contract under paragraph 7(a) of FASB Statement No. 60 (AC In6.107), (2) the contract must not contain features that prevent the risk transfer criteria in paragraphs 8 through 13 of FASB Statement No. 113 (AC sections In6.171-174 and In6.176-177) from being reasonably applied (and those criteria must be met), and (3) the ultimate premium expected to be paid or received under the contract must be reasonably estimable and allocable in proportion to the reinsurance protection provided as required by paragraph 14(a) and (b) of FASB Statement No. 60 (AC In6.114) and paragraph 21 of FASB Statement No. 113 (AC In6.185). If any of these conditions are not met, a deposit method of accounting should be applied by the ceding and assuming enterprises.

FASB Financial Instruments Project

.61 The FASB's agenda continues to include a project on financial instruments that encompasses three primary segments: disclosures, distinction between liabilities and equity, and recognition and measurement. In addition to these three primary segments, the FASB has addressed several narrower issues within the overall scope of the project. Some of the current developments of the project are described in the following sections.

.62 *Impairment of a Loan.* In May 1993, the FASB issued FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan* (AC I08), which addresses the accounting by creditors for impairment of certain loans. The Statement is applicable to all creditors and to all loans, uncollateralized as well as collateralized, except large groups of smaller-balance homogeneous loans that are collectively valued for impairment, loans that are measured at fair value or at the lower of cost or fair value, leases, and debt securities as defined in FASB Statement No. 115 (AC I80). It applies to all loans that are restructured in a troubled debt restructuring involving a modification of terms.

.63 FASB Statement No. 114 (AC I08) requires that impaired loans that are within its scope be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or as a practical expedient, at the loan's observable market price or the fair value of collateral if the loan is collateral-dependent.

.64 The Statement amends FASB Statement No. 5 (AC C59) to clarify that a creditor should evaluate the collectibility of both contractual interest and contractual principal of all receivables when assessing the need for a loss accrual. The Statement also amends FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructuring* (AC D22), to require a creditor to measure all loans that are restructured in a troubled debt restructuring involving a modification of terms in accordance with its provisions.

.65 The Statement applies to financial statements for fiscal years beginning after December 15, 1994. Earlier application is encouraged.

.66 Sources of guidance relevant to auditing loan loss allowances are described in paragraph .30.

.67 Some insurers may adopt the provisions of the Statement prior to its effective date. Auditors of the financial statements of such insurers should carefully consider the implications of applying the new provisions of the Statement on audit risk. Aspects of applying the new Statement that warrant particular consideration include—

- Proper identification of all loans to which the Statement should be applied.
- The reasonableness of estimates of future cash flows and interest rates used in discounting.
- The appropriateness of amounts used to measure impairment if alternatives to present value amounts, such as fair values of collateral or observable market prices, are used.

- The relationship between the identification of impaired loans under the Statement and the classification of loans under regulatory classification systems.
- The presentation of accrued interest receivable and its relationship to valuation allowances.
- The relevance of concepts of performing and nonperforming assets.

.68 *Investments in Debt and Equity Securities.* In May 1993, the FASB issued FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (AC I80), which addresses the accounting and reporting for investments in equity securities that have readily determinable fair values (previously addressed by FASB Statement No. 12, *Accounting for Certain Marketable Equity Securities* [AC I89]) and for all investments in debt securities. FASB Statement No. 115 (AC I80) does not cover securities accounted for by the equity method and investments in consolidated subsidiaries. FASB Statement No. 115 (AC I80) establishes three categories of reporting debt and marketable equity securities:

- Held-to-maturity securities (debt securities that the insurer has the positive intent and ability to hold to maturity), to be reported at amortized cost
- Trading securities (debt and equity securities that are bought and held principally for the purpose of selling them in the near future), to be reported at fair value, with unrealized gains and losses included in earnings
- Available-for-sale securities (debt and equity securities not classified as either held-to-maturity or trading), to be reported at fair value, with unrealized gains and losses excluded from earnings and reported in a separate component of equity until realized

Mortgage-backed securities that are held for sale in conjunction with mortgage-banking activities (as described in FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities* [AC Mo4]), are classified as trading securities. Mortgage-backed securities that are currently not held-for-sale in conjunction with mortgage-banking activities may be classified in one of the two other categories, as appropriate.

.69 FASB Statement No. 115 (AC I80) also requires insurers to determine whether declines in the fair value of individual securities classified as either held-to-maturity or available-for-sale below their amortized cost bases are other than temporary. For example, if it is probable that an investor will be unable to collect all amounts due according to the contractual terms of a debt security not impaired at acquisition, an other-than-temporary impairment is considered to have occurred. If such a decline is judged to be other than temporary, the cost basis of the individual security should be written down to fair value as the new cost basis, with the amount of the write-down included in earnings (that is, accounted for as a realized loss).

.70 The Statement also specifies the accounting treatment for transfers between categories.

.71 The Statement (paragraph 8 [AC I80.105]) indicates that certain changes in circumstances may cause the enterprise to change its intent to hold a certain security to maturity without calling into question its intent to hold other debt securities to maturity in the future. Such circumstances include evidence of a significant deterioration in the issuer's creditworthiness or a change in tax law that eliminates or reduces the tax-exempt status of interest on the debt security. In addition, other events that are isolated, nonrecurring, and unusual for the reporting enterprise that could not have been reasonably anticipated may cause an enterprise to sell or transfer a held-to-maturity security without necessarily calling into question its intent to hold other debt securities to maturity. Such sales and transfers of held-to-maturity securities are expected to be rare.

.72 An entity shall not classify a debt security as held-to-maturity if it has the intent to hold the security for only an indefinite period. Consequently, a debt security should not, for example, be classified as held-to-maturity if the enterprise anticipates that the security would be available to be sold in response to changes in market interest rates and related changes in the security's prepayment risk, needs for liquidity, changes in the availability of and the yield on alternative investments, changes in funding sources and terms, and changes in foreign-currency risk.

.73 FASB Statement No. 115 (AC I80) is effective for fiscal years beginning after December 15, 1993. It specifically prohibits retroactive restatement of prior financial statements. Although typically FASB Statement No. 115 (AC I80) would be initially applied as of the beginning of a fiscal year (such as January 1, 1994), entities are permitted to initially apply the Statement as of the end of an earlier annual period for which financial statements have not been issued (with no restatement of interim periods).

.74 Since all insurers with a calendar fiscal year must classify their investments in securities in accordance with FASB Statement No. 115 (AC I80) as of January 1, 1994, those insurers will also be able to apply the Statement as of December 31, 1993, if they wish to do so in their 1993 annual financial statements. Thus, auditors should be aware of some of the issues that are likely to arise when the Statement is applied. Auditing financial statements involving the classification of investments in debt and equity securities pursuant to FASB Statement No. 115 (AC I80) may involve a high degree of judgment about such matters as the following:

- How auditors should evaluate subjective exceptions for sales of securities designated as held-to-maturity (including the interpretation of restrictive terms such as *isolated, nonrecurring,* and *unusual*)
- How auditors should evaluate the ability of an insurer to hold securities to maturity, particularly when going-concern issues arise
- Whether cash flow projections are needed in conjunction with assessing an insurer's ability to hold securities to maturity
- How to evaluate whether impairments of investments are other than temporary

Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance Companies

.75 In April 1993, the FASB issued Interpretation No. 40, *Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises* (AC In6), an interpretation of FASB Statements No. 12, *Accounting for Certain Marketable Securities* (AC I89), No. 60 (AC In6), and No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Contracts* (AC In6). The Interpretation clarifies that companies, including mutual life companies, that issue financial statements described as prepared "in conformity with generally accepted accounting principles" are required to apply all applicable authoritative accounting pronouncements in preparing those statements. The Interpretation concludes that mutual life insurance companies, who, like a number of other regulated companies, prepare financial statements based on regulatory accounting practices that differ from generally accepted accounting principles and distribute those financials to regulators, should not describe these financial statements as prepared "in conformity with generally accepted accounting principles."

.76 The Interpretation is effective for financial statements issued for fiscal years beginning after December 15, 1994, except for the disclosure provisions, which are effective for fiscal years beginning after December 15, 1992. Earlier application is encouraged. The disclosures required to be made by mutual insurance companies for fiscal years beginning after December 15, 1992 include—

- The accounting principles and methods used to account for investments in debt and equity securities and insurance activities in accordance with Accounting Principles Board (APB) Opinion No. 22, *Disclosure of Accounting Policies* (AC A10).
- A brief description of Interpretation No. 40 (AC In6), including its effective date and transition provisions, and that financial statements prepared on the basis of statutory accounting principles will no

longer be described as prepared in conformity with generally accepted accounting principles after the effective date of this Interpretation.

Disclosures of Certain Matters in the Financial Statements of Insurance Entities

.77 The AICPA plans to expose for public comment a proposed SOP, *Disclosures of Certain Matters in the Financial Statements of Insurance Entities*, in the first quarter of 1994. The proposed SOP would require (1) all property and liability insurance companies to make additional disclosures about their liability for unpaid claims, (2) all insurance companies to make additional disclosures about the differences between accounting methods permitted for certain transactions, and (3) certain risk-based capital disclosures for life insurance companies.

Disclosures—Publicly Held Companies

.78 *Management's Discussion and Analysis.* SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AU section 550), requires that auditors read such information and consider whether it and the manner of its presentation are materially consistent with information appearing in the financial statements. As auditors of insurance companies that are required to file reports with the SEC read the Management's Discussion and Analysis of Operations (MD&A) sections of SEC filings, they might consider whether the MD&A includes discussions of—

- The effects of reinsurance on results of operations and liquidity. Effects of catastrophes should be discussed both gross and net of reinsurance, in the aggregate and for material individual catastrophes. Recent large catastrophes have caused substantial changes in the relationships between reinsurance premiums and related loss recoveries from historical levels.

- The quantitative characteristics of their policy liabilities, including expected duration, interest crediting rates, and surrenderability, and the relationship of these characteristics to the characteristics of the investment portfolio that supports the liabilities. The liabilities of life insurance companies are fundamentally different from those of property and liability insurance companies; therefore, multi-line insurance companies generally should discuss each separately.

- The impact of recently issued accounting standards which are not effective until some future date. If the adoption of a standard is expected to have a significant effect on the insurance company's financial position or results of operations, the MD&A disclosure should (1) notify that a standard has been issued which the insurance company will be required to adopt in the future, and (2) assess the significance of the impact that the adoption of the standard should have on the company's financial statements (unless this cannot be reasonably estimated, in which case, a statement to that effect should be made).

- The potential consequences of failure to meet the NAIC RBC requirements, as well as disclosure of the actual and required RBC amounts.

.79 *Environmental Issues.* The Environmental Protection Agency is empowered by law to seek recovery from any party that ever owned or operated a contaminated site and from anyone who ever generated or transported hazardous materials to a site. In view of the liabilities that may result from owning contaminated sites, virtually all real estate transactions entered into today give consideration to potential environmental liabilities. Auditors of insurance entities that face such claims in connection with property they insure or in connection with their own real estate holdings and transactions or otherwise should carefully evaluate whether the accounting and disclosure requirements of FASB Statement No. 5 (AC C59) have been met. They should also be cognizant of the consensus reached by the FASB's EITF in Issue 93-5, *Accounting for Environmental Liabilities*, that, among other things, an environmental liability should be evaluated independently from any potential recovery and that the loss arising from the recognition of an environmental liability should be reduced only when a claim for recovery is probable of realization.

.80 Auditors of publicly held insurance entities should also consider the adequacy of note disclosures of the nature and magnitude of environmental claims, including the range of possible loss, or a statement that it is not estimable. Such disclosures should be made in accordance with the requirements of SEC Staff Accounting Bulletins (SABs) No. 87, *Views on Contingency Disclosures on Property-Casualty Insurance Reserves for Unpaid Claim Costs,* and No. 92, *Accounting and Disclosures Relating to Loss Contingencies.* SAB No. 92 also provides the SEC staff's interpretation of current accounting literature related to the following:

- Offsetting of probable recoveries against probable contingent liabilities
- Recognition of liabilities for costs apportioned to other potential responsible parties
- Uncertainties in estimation of the extent of environmental or product liability
- The appropriate discount rate for environmental or product liabilities, if discounting is appropriate
- Accounting for exit costs
- Financial statement disclosures and disclosure of certain information outside the basic financial statements

.81 Auditors should also consider the adequacy of accounting policy disclosures for reserves, which should state clearly whether a provision for incurred-but-not-reported claims is included. Auditors should also consider whether disclosures include reserve balances and activity relating to environmental and product liability claims for periods covered by financial statements, along with a discussion of related trends and uncertainties. These disclosures should be made under the guidelines of SEC Industry Guide 6 and Item 303 of Regulation S-K. *Audit Risk Alert—1993* [AAM section 8010] includes a detailed discussion of additional accounting and auditing issues relating to environmental costs.

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.82 This Audit Risk Alert replaces *Insurance Industry Developments—1992.*

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.83 Auditors should also be aware of the economic, regulatory, and professional developments that may affect the audits they perform, as described in *Audit Risk Alert—1993* [AAM section 8010].

[The next page is 8135.]

AAM Section 8050

Banks and Savings Institutions Industry Developments—1993

Industry and Economic Developments

.01 By traditional measures, banks and savings institutions made progress during 1993. With interest rates at twenty-five-year lows and relative improvements in credit quality, the industry overall showed continued profits. This financial progress—achieved through increased interest-rate spreads and reduced credit losses—has also begun to shift the industry's risk focus from credit quality to interest-rate risk.

.02 Just as low interest rates have sustained low funding costs and increased spreads, continued uncertainty about the general economy and inflation has fed uncertainty about how long rates can remain so low. While enjoying relatively wide interest-rate spreads, prudent institutions have been managing their balance sheets to achieve asset/liability mixes that limit exposure to the negative impact of any sudden flattening or upward shift of the yield curve. The potential for such shifts creates risk, particularly for institutions that invest heavily in longer-term, fixed-rate assets. And though credit quality continues to require critical attention, the relative earnings impact of credit losses has declined as institutions have bolstered related allowances. Real estate markets, while not surging into recovery, have generally stopped declining and often shown limited but steady improvement in most regions (Southern California being the major exception).

.03 Developments during 1993, however, highlight a movement by many banks and savings institutions to look beyond interest-rate spreads and credit quality issues in meeting industry challenges. Those institutions are seeking to develop new activities, react creatively to new competition, and rein in regulation.

.04 With commercial loan demand stagnant, the industry has continued its press for authority to enter into new and broader activities (such as insurance and securities) and to expand institutions' geographical limits. At the same time, the number of nonbank institutions competing for savings dollars continues to increase. Finally, many argue that regulations, including limitations and restrictions introduced by the Federal Deposit Insurance Corporation (FDIC) Improvement Act of 1991 (FDICIA), affect institutions' ability to both enter into new activities and compete on a level basis in those and existing activities. Institutions have dramatically increased fee-based services as a way to fill the void left by declining lending activity. For example, mutual fund activity at banks and savings institutions has increased, in part, to hold ground in the competition for savings, but also to participate in the many fees generated. The new rewards brought by entry into mutual fund activities are accompanied by new risks. Although some view such activity as progress in recapturing business from nonbank competitors, others attribute growth in this area to a simple shifting of traditional deposits and trust and custodial funds. Questions have been raised about the ability of institutions to attract deposit funds back from mutual fund customers. If loan demand rises, some argue, deposits could be more difficult to attract without increasing deposit rates and, therefore, funding costs.

.05 In addition to pursuing the breaking down of regulatory barriers to such new activities, industry representatives have continued a call for the elimination of regulations they believe are overburdening. They argue that many requirements add unnecessary cost and impair institutions' ability to compete with nontraditional competitors for traditional business.

.06 Other trends evident in 1992 continued in 1993. For example, demand for real estate mortgage loans was particularly heavy as borrowers refinanced at lower interest rates. Though some improvements have been made in consumer confidence and spending, demand for all other loans was generally flat. The year 1993 also saw continued consolidation of the industry through mergers and acquisitions.

.07 As part of the planning process, auditors should consider how changes in the business of client institutions in response to industry pressures affect audit risk.

Regulatory and Legislative Developments

.08 Major federal legislative proposals during 1993 centered on consolidation of federal banking and thrift regulatory agencies and repeal of certain FDICIA provisions and other regulations considered burdensome. Little prospect is seen for major banking legislation by the current Congress.

FDIC Improvement Act of 1991

.09 Implementation of the FDICIA was the source of most regulatory developments during the year. The AICPA's Audit Risk Alert, *FDIC Improvement Act Implementation Issues* [AAM section 8190], provides auditors who serve FDIC-insured banks and savings institutions with an overview of how implementation of the FDICIA affects the engagements they perform. Under key provisions of the FDICIA, auditors serving covered institutions will be required—for the first time—to attest to managements' assertions about internal controls over financial reporting and compliance with certain laws and regulations. Auditors should become familiar with the new reporting requirements, particularly those that address the auditor's qualifications, exposure to enforcement actions, required communications with client institutions, and interaction with the audit committee. The effects of a number of the law's provisions on a client institution's ability to remain a going concern should also be considered.

.10 The reporting requirements created in new Section 36 of the Federal Deposit Insurance Act, as added by Section 112 of the FDICIA, are discussed in detail in *FDIC Improvement Act Implementation Issues* [AAM section 8190]. To implement Section 36, the FDIC issued both a final regulation and accompanying guidelines and interpretations, which are codified in Section 12 of the Code of Federal Regulations (CFR) Part 363. Information and guidance on implementation of Section 36 developed since issuance of *FDIC Improvement Act Implementation Issues* [AAM section 8190] is presented in the "Audit Issues and Developments" section herein.

Other Regulatory Matters

.11 Other major regulatory developments during 1993 centered on discriminatory lending practices and credit availability. The federal banking agencies set forth several initiatives on fair lending, including those that provide additional guidance for examiners to better the effectiveness of examinations to detect whether or not illegal discrimination has occurred at an institution. In March, the Clinton administration announced an initiative to increase the availability of credit. The initiative included proposals to (1) clarify that examination and rating procedures are not meant to group "special mention" loans with classified loans, (2) review rules on the reporting treatment and classification of loans made to facilitate the sale of other real estate owned, and (3) work with the appropriate authorities to coordinate changes in accounting principles and reporting standards for in-substance foreclosures and for returning certain loans to accrual status. The resulting policy statements, issued jointly by the Office of the Comptroller of the Currency (OCC), the FDIC, the Board of Governors of the Federal Reserve System (FRB), and the Office of Thrift Supervision (OTS) (collectively, the federal banking regulatory agencies) are described below.

.12 Laws and their implementing regulations affect the areas and ways in which banks and savings institutions operate, while creating standards with which those institutions must comply. Some laws and regulations directly address the responsibilities of auditors. Auditors should be familiar with regulations because of the impact regulations have on the auditor's—

- Acceptance of engagements in the depository institutions industry.
- Planning activities (that is, development of the expected conduct and scope of an engagement).
- Responsibility for detection of errors and irregularities.

- Evaluation of contingent liabilities and related disclosures.
- Consideration of an institution's ability to continue as a going concern.

As required by AICPA Statement on Auditing Standards (SAS) No. 22, *Planning and Supervision* (AU section 311), auditors should consider matters affecting the industry in which the entity operates, such as government regulations. In that regard, it is helpful for auditors to be familiar with the nature and purpose of regulatory examinations—including the differences and relationship between examinations and financial statement audits.

.13 Finally, an understanding of the regulatory environment in which institutions operate is necessary to complement the auditor's knowledge of existing regulatory requirements. Because the regulatory environment is continually changing, the auditor should monitor relevant regulatory changes and consider their implications in the audit process.

.14 Summarized below are regulatory developments of particular significance in audits of the financial statements of FDIC-insured banks and savings institutions. Other regulatory releases, covering other policy areas such as the Home Mortgage Disclosure Act and the Community Reinvestment Act, are not within the scope of this document. The highlights that follow are not intended to provide a comprehensive discussion of each issue and should not be substituted for a complete reading of related regulations, rulings, or other documents, where appropriate (see the "Information Sources" section herein). References to such documents are provided with each paragraph, as appropriate.

Regulatory Capital

.15 Because of the complexity of capital regulations, their application requires a thorough understanding of specific requirements and the potential impact of any instance of noncompliance—particularly when an institution is involved in complex transactions, investments, or parent-subsidiary relationships. Highlights of major changes in capital regulations are presented below.

.16 *Capital Adequacy Guidelines.* In addition to the capital matters addressed by the prompt corrective action provisions of the FDICIA, the federal banking regulatory agencies continue to administer minimum capital adequacy requirements. The OCC, the FDIC, and the FRB require institutions to maintain a minimum leverage-capital ratio of Tier I capital (as defined) to total average assets based on bank ratings under the regulatory CAMEL rating system. Banks with composite CAMEL ratings of one that are not anticipating or experiencing significant growth and have well diversified risk are required to maintain a minimum leverage capital ratio of 3.0 percent. An additional 100 to 200 basis points are required for all but these most highly rated institutions.

.17 Beginning December 31, 1992, banks also must maintain a minimum ratio of total capital to risk-weighted assets of 8.0 percent, and a minimum ratio of Tier I capital to risk-weighted assets of 4.0 percent.

.18 The OTS requires savings institutions also to maintain a minimum core-capital ratio (as defined) of 3.0 percent and a minimum tangible capital ratio of 1.5 percent of assets. The determination of tangible capital requires the immediate deduction of all unamortized supervisory goodwill arising from the purchase of a troubled institution prior to April 12, 1989. For core capital calculations, unamortized supervisory goodwill is being deducted on a phased schedule and will be fully deducted by January 1, 1995.

.19 Litigation against the federal government continues to be pursued by numerous savings institutions seeking injunctive relief from the Financial Institutions Reform, Recovery, and Enforcement Act of 1989's phasing out of supervisory goodwill. In August, the U.S. Court of Appeals for the Federal Circuit agreed to rehear one such case after favorable summary judgments were overturned on appeal. The vastly different fact patterns involved in the various cases leave in question the outcome of the litigation and its implications for other institutions with supervisory goodwill.

.20 For savings institutions, the OTS-required minimum total risk-based capital ratio (the total of core and supplemental capital) increased from 7.2 to 8.0 percent effective December 31, 1992. The minimum requirement for core capital included in total thrift risk-based capital increased from 3.6 to 4.0 percent as of December 31, 1992.

.21 *Intangible Assets.* Under revised rules issued in 1993, institutions must generally deduct from regulatory capital all intangible assets other than limited amounts of purchased mortgage servicing rights (PMSRs) and purchased credit card relationships (PCCRs). PMSRs and PCCRs may be included in regulatory capital only to the extent that, in the aggregate, they do not exceed 50 percent of Tier I capital, as defined. PCCRs are further limited to 25 percent of Tier I capital. For purposes of calculating Tier I capital, the amount of PMSRs and PCCRs cannot exceed the lesser of 90 percent of the fair market value or 100 percent of the book value. Core deposit intangibles and goodwill are deducted in total from capital. Among other restrictions imposed by the final rule, institutions are required to determine the fair market value—and to review the book value—of their PMSRs and PCCRs at least quarterly. Further, impairment tests for regulatory financial reporting purposes must be made on a discounted basis. The OTS has not yet issued its final rule. The OTS has proposed that PMSRs purchased (or under contract to be purchased) on or before February 9, 1990, not be subject to certain concentration limitations (12 CFR Parts 3, 208, 225, and 325; FDIC Financial Institution Letter [FIL]-8-93; OCC Banking Bulletin [BB] 93-16; OTS Thrift Bulletin [TB] 60).

.22 *Deferred Tax Assets Recognized Under FASB Statement No. 109.* The agencies are proposing revisions to their capital adequacy guidelines for regulatory treatment of deferred tax assets arising under application of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes* (AC I27). FASB Statement No. 109 (AC I27) addresses recognition of deferred tax assets that arise from either deductible temporary differences, as defined, or carryforwards of net operating losses or tax credits. The Statement requires that a valuation allowance be established to reduce any deferred tax assets to the amount considered more likely than not to be realized. The Federal Financial Institutions Examination Council (FFIEC) has directed that FASB Statement No. 109 (AC I27) be adopted for purposes of FFIEC Consolidated Reports of Condition and Income (Call Reports). In conjunction with this reporting change, the FFIEC recommended that the agencies amend their capital rules to limit the amount of deferred tax assets that may be included in regulatory capital. The FFIEC has also proposed to the federal bank regulatory agencies that deferred tax assets be included in regulatory capital without limit if they can be realized from taxes paid in prior carryback years and from future reversals of existing taxable temporary differences. However, deferred tax assets that are dependent on future taxable income would be limited in regulatory capital to the lesser of the amount expected to be realized within one year (exclusive of tax carryforwards and reversals of existing temporary differences) or 10 percent of Tier I capital (before deduction of any disallowed PMSRs, PCCRs, or deferred tax debits). The FDIC and the FRB have issued and received comments on the proposed limit. The OCC's proposal is forthcoming. Interim guidance requires banks to report the amount of deferred tax assets that would be disallowed under the proposed limit in regulatory reports (12 CFR Parts 208, 225 and 325; FDIC FIL-36-93 and FIL-27-93; OCC BBs 93-2 and 93-15, and Examining Bulletin 93-5; OTS TB 56).

.23 *Interest-Rate Risk.* Section 305 of the FDICIA requires the federal banking regulatory agencies to revise their risk-based capital guidelines as necessary to ensure adequate consideration of interest-rate risk. The FDIC, the OCC, and the FRB have proposed a measure of interest-rate risk exposure and an approach for assessing capital adequacy for interest-rate risk as revisions to the existing risk-based capital guidelines. Under the proposal, additional reporting would begin with March 1994 Call Reports, with full implementation of the guidelines by December 31, 1994 (FDIC FIL-65-93; OCC BB 93-52).

.24 Effective July 1, 1994, the OTS is adding an interest-rate risk component to its risk-based capital requirements. Institutions with a greater than normal interest-rate exposure, as defined, must take a deduction from the total capital available to meet their risk-based capital requirement, equal to one-half of the difference between the institution's actual measured exposure and a defined normal level of exposure (*Federal Register*, August 31, 1993).

Credit Quality

.25 The allowance for loan and lease losses and liabilities for other credit exposures require critical attention in audits of financial statements of banks and savings institutions. Regulatory releases during 1993 that are specific to credit loss allowances include those noted below.

.26 *Review and Classification of Commercial Real Estate Loans.* In a joint statement issued on June 10, the federal banking regulatory agencies reaffirmed their November 7, 1991, policy statement to ensure that all supervisory personnel are using that earlier guidance in their review of commercial real estate loans. The November 1991 guidance emphasizes that the evaluation of commercial real estate loans by examiners is based on a review of the borrower's willingness and capacity to repay and on the income-producing capacity of the underlying collateral over time. It states that the value of collateral increases in importance as the loan becomes troubled and the borrower's ability to repay the loan becomes more questionable. The statement emphasizes that it is not regulatory policy to value collateral that underlies real estate loans on a liquidation basis. It also discusses management's responsibility for reviewing appraisal assumptions and conclusions for reasonableness, emphasizing that appraisal assumptions should not be based solely on current conditions that ignore the stabilized income-producing capacity of the property (OCC BB 93-36).

.27 *Special Mention Assets.* The federal banking regulatory agencies' *Interagency Statement on the Supervisory Definition of Special Mention Assets,* issued June 10, adopts a uniform definition of special mention assets and emphasizes that special mention assets may be criticized for potential weakness but are not included in or considered classified assets (OCC BB 93-35).

.28 *In-Substance Foreclosures.* On June 10, a joint statement, *Interagency Guidance on Reporting of In-Substance Foreclosures,* was issued in which the federal banking regulatory agencies concluded that losses on real estate loans for which collateral is considered in-substance foreclosed under existing generally accepted accounting principles (GAAP) criteria should be measured and recognized in regulatory financial reports based on the fair value of the collateral. However, the agencies also affirmed that such loans need not be reported as other real estate owned unless possession of the underlying collateral has been obtained. Rather, they would remain in the loan category (OCC BB 93-37).

.29 *Interest Accrual Status of Certain Loans.* Another June 10 joint statement, *Revised Interagency Guidance on Returning Certain Nonaccrual Loans to Accrual Status,* conforms federal regulatory policies to permit certain loans restructured through use of multiple notes to be returned to interest accrual status. The policy also provides criteria under which loans that may not be fully current as to principal and interest payments can be returned to interest accrual status (OCC BB 93-37).

.30 *Allocated Transfer Risk Reserves.* In October 1992, the OCC, the FRB, and the FDIC issued a joint statement concerning the applicability of allocated transfer risk reserves to equity or debt securities resulting from debt-for-equity or debt-for-debt exchanges (OCC BB 92-63).

.31 *Troubled, Collateral-Dependent Loans.* Effective September 30, 1993, OTS policy requires savings institutions to record certain troubled, collateral dependent loans in OTS Thrift Financial Reports (TFRs) at their present value discounted at the loan's contractual interest rate. Any excess of the loan balance over the present value is to be classified as loss, with the remainder generally classified as substandard.

.32 The OTS policy considers it to be probable that a lender will be unable to collect all amounts due under the contractual terms of a loan when the expected future cash flows, on an undiscounted basis, from the operation and sale of the collateral over a period of time not to exceed five years, are less than the principal and interest payments due according to the contractual terms of the loan (OTS Regulatory Bulletin [RB] 31).

Other Areas of Regulation

.33 *Real Estate Lending Standards.* Effective March 19, 1993, the federal banking regulatory agencies established uniform regulations prescribing real estate lending standards. The regulations require subject institutions to maintain various written policies for real estate lending that should reflect consideration of guidelines that outline considerations for portfolio management, underwriting standards, loan administration, loan-to-value limits, and policy exceptions (12 CFR Part 34; OCC BB 92-75).

.34 *Loan Documentation.* The federal banking regulatory agencies established a policy on loan documentation effective March 30, 1993, to encourage lending to small- and medium-sized businesses. The policy allows certain banks and savings institutions to establish a portfolio of loans exempt from certain documentation requirements. Examiners may not criticize the credit quality of an exempt loan on the basis of documentation and may not classify the loan unless it is more than sixty days delinquent. The institution's management, however, is still required to fully evaluate the collectibility of exempt loans in determining the adequacy of loan loss allowances.

.35 An institution's exempt portfolio could be material to its financial statements. Auditors of the financial statements of banks and savings institutions should be aware that the exemption of such loans from examiner review and criticism does not extend to the auditor's responsibility in financial statement audits or other engagements involving management assertions about the exempt loans. An auditor's assessment of management assertions about credit quality may depend on the availability of certain documentation, including adequate collateral appraisals or current and complete financial information about borrowers or guarantors. The new policy may affect the availability of such documentation. Existing auditing literature provides guidance on determining the scope of procedures to be applied to such loans and cautions auditors against undue reliance on management representations when no supporting evidence exists. This guidance is provided in the AICPA's Audit and Accounting Guide *Audits of Savings Institutions,* Industry Audit Guide *Audits of Banks,* and Auditing Procedure Study *Auditing the Allowance for Credit Losses of Banks* (FDIC FIL-63-93; OCC BBs 93-18, 93-23, and 93-46; OTS TB 61).

.36 *Limitations on Activities of State Banks.* FDIC-insured state institutions and their majority-owned subsidiaries are prohibited from conducting activities "as principal" that are not permitted for national banks. In late 1992, new restrictions were placed on the ability of such institutions to hold equity investments in corporate stock and mutual fund shares, and to make other investments (for example, in real estate development projects). In February, the FDIC proposed other restrictions on state institutions' activities (12 CFR Part 362; FDIC FIL-80-92, FIL-83-92, and FIL-9-93).

.37 *Deposit Insurance Premiums.* In June, the FDIC modified the traditional risk-based deposit insurance premium system that took effect on January 1, 1993. Under the modified system, premium rates are based on the risk banks and savings institutions pose to the insurance funds. Institutions pay a premium within a range of 23 to 31 cents per $100 of domestic deposits, depending on the institution's risk classification. The modified system is effective October 1, 1993 for the assessment period beginning January 1, 1994 (12 CFR Part 327; FDIC FIL-48-93 and FIL-47-93).

.38 *Interbank Liabilities.* FRB regulations that took effect on June 19, 1993 require institutions to evaluate and control the credit and liquidity risk they take on in transactions with other banks and savings institutions (other than institutions under common control). Transactions covered by the rules include those for which the exposed institution must carry capital under risk-based capital adequacy guidelines. The rules require an institution to set limits on its credit and settlement exposure to each individual correspondent institution and establish benchmark limitations based on the exposed institution's capital. Beginning June 19, 1994 the overnight credit exposure of an institution to correspondents that are not at least adequately capitalized, as defined, is limited to 50 percent of the exposed institution's capital. The limitation falls to 25 percent as of June 19, 1995 (12 CFR Part 206; FDIC FIL-10-93; OCC BB 93-3).

.39 *Express Determination Letters.* Federal tax law permits banks and savings institutions to make bad debt deductions for loans charged off because of uncollectibility. The Internal Revenue Service (IRS) seeks evidence to ensure that loans are being charged off appropriately. In 1992, the IRS issued regulations that permit an institution to obtain evidence from their primary regulators stating that the institution maintains and applies loan review and loss classification standards consistent with the agency's regulations regarding loan charge-offs. The federal banking regulatory agencies issued guidance in late 1992 to implement the express determination letter process (FDIC FIL-76-92; OCC BB 92-57).

.40 *Appraisals.* In late 1992, the FDIC issued additional guidance on appraisal and evaluation programs for real estate transactions and for conducting appropriate evaluations of real estate for transactions that are exempt from required appraisals by certified or licensed appraisers (12 CFR Part 323; FDIC FIL-69-92). In June, the federal banking agencies proposed a rule for real estate appraisals that would expand and clarify existing exemptions and identify new exemptions. Included would be an increase in the threshold level for required appraisals to real estate-related financial transactions (as defined) having a value of $250,000 or greater (12 CFR Parts 34, 225, 323, 545, 563, and 564; FDIC FIL-44-93; OCC BB 93-32).

.41 *Mortgage Derivatives.* In late 1992, the FDIC issued additional guidance on the supervisory treatment of mortgage derivative products such as collateralized mortgage obligations (CMOs), real estate mortgage investment conduits (REMICs), stripped mortgage-backed securities and residual tranches of CMOs and REMICs. An earlier interagency policy statement applicable to mortgage derivatives obtained on or after February 10, 1992 allows regulatory examiners to require that an institution divest itself of high-risk mortgage derivatives, as defined, that do not reduce an institution's interest-rate risk or are not held in a trading account (see FDIC FIL-7-92). The additional FDIC guidance provides specific guidelines for determining whether a derivative is high-risk and the appropriate regulatory treatment (FDIC FIL-64-92).

.42 *Securities Exchange Act Disclosure Rules.* Effective November 6, 1992, the OCC revised its regulations to incorporate the Securities and Exchange Commission (SEC) regulations related to the Securities and Exchange Act of 1934 (the Act) by reference, rather than continuing to maintain its own regulations as authorized under Section 12(i) of the Act. Among other results, the change requires registered national banks to have an annual independent financial statement audit and to adopt disclosures prescribed by Securities Exchange Act Industry Guide 3, including SEC criteria for disclosures of loans and extensions of credit to insiders (12 CFR Parts 5, 11 and 16; OCC BB 92-58).

.43 *Bank Secrecy Act.* OTS Bulletin PA-7a-3 requires savings institutions to provide an auditor's report on procedures and findings relative to compliance with certain provisions of the Bank Secrecy Act and related regulations. The auditor's report has historically been prepared following the guidance of SAS No. 30, *Reporting on Internal Accounting Control.*

.44 SAS No. 30 has been superseded by Statement on Standards for Attestation Engagements (SSAE) No. 2, *Reporting on an Entity's Internal Control Structure Over Financial Reporting* (AT section 400). SSAE No. 2 (AT section 400) is effective for managements' financial reporting control assertions as of December 15, 1993 and thereafter. Further, the OTS is considering withdrawing Bulletin PA-7a-3.

.45 Guidance on performance of engagements required by Bulletin PA-7a-3 is forthcoming.

.46 *Unrealized Gains and Losses on Securities.* On August 10, the FFIEC announced that it would adopt FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (AC I80), for regulatory reporting purposes. The FFIEC announcement also stated that the federal banking regulatory agencies will be requesting comments on whether unrealized gains and losses on securities designated as available for sale under FASB Statement No. 115 (AC I80) should be included in Tier I capital for risk-based and leverage capital purposes (OTS Chief Executive Officer [CEO] Letter dated August 16, 1993).

.47 *Accounting for Dispositions of Other Real Estate Owned.* On July 16, the federal banking regulatory agencies issued a joint statement revising Call Report instructions for sales of other real estate owned (beginning with the June 30, 1993 report date) to substantially follow GAAP. Once the criteria for sale treatment under FASB Statement No. 66, *Accounting for Sales of Real Estate* (AC Re1), are met, the receivable resulting from the sale of the real estate may be reported as a loan in regulatory financial reports (FDIC FIL-49-93; OCC BB 93-42). The OCC issued a final rule in September to clarify how national banks may dispose of other real estate owned (OCC BB 93-51).

.48 *Mortgage Banking.* On May 28, the OCC issued an advisory stating its expectation that national banks perform mortgage banking operations in a safe and sound manner. The advisory stressed that national banks have policies and procedures in place to monitor and control mortgage banking activities, such as loan production, pipeline and warehouse administration, secondary market transactions, servicing operations, and management of PMSRs and excess servicing fee receivables. The OCC emphasized that institutions' policies and procedures should address—

- Comprehensive documentation standards for all aspects of mortgage banking activities.
- Accurate financial reporting systems and controls.
- Plans to manage interest-rate risk.
- Impairment analyses that use accurate, realistic assumptions.
- Systems that track and collect required mortgage loan documents.

A related banking circular is expected to be issued in the near future.

.49 *Examination Coordination.* The agencies issued a joint statement in June outlining a program for coordinating exams of insured banks and savings institutions and inspections of their holding companies by federal banking regulatory agencies. The primary objectives of the policy statement are to eliminate duplication in examinations by multiple agencies, increase coordination between agencies when duplication is necessary, and establish procedures to centralize and streamline examinations in multibank organizations (OCC BB 93-38).

.50 *Purchases of Life Insurance.* In August, the FDIC issued guidance to examiners on purchases of life insurance by FDIC-supervised institutions. The guidance, communicated in a Regional Director Memorandum (Transmittal No. 93-125), includes regulatory accounting considerations (FDIC FIL-60-93).

.51 *Examination Appeals Process.* The OCC revised its appeals process by establishing procedures for review of supervisory decisions through an ombudsman (OCC Banking Circular [BC] 272). The OTS set forth new guidelines for its supervisory review process in September (OTS RB 4a).

.52 *New Audit Requirements in Effect for Lenders, Servicers, and Other Participants in Student Financial Assistance.* The U.S. Department of Education has issued new audit requirements for lenders, servicers, and guarantors participating in certain federally funded student financial assistance programs. The requirements were included in regulations issued in December 1992 and relate to the Federal Family Education Loan Programs (FFELP) (*Federal Register*, December 18, 1992) and/or in the Higher Education Amendments Act of 1992 (HEAA) relating to Title IV programs, which Congress passed in July 1992.

.53 The regulations require guarantors of loans granted under the programs to have financial compliance audits of FFELP agencies, which previously was a biennial requirement, and annual compliance audits of participating lenders covering the lender's first fiscal year that begins after July 23, 1992. Guarantor audits must be conducted in accordance with either OMB Circular A-128 or A-133, depending on whether the guarantor is a state agency or a not-for-profit organization. Lender audit reports must be completed within six months after the end of an audit period. Implementation guidance on lender compliance audits is currently being drafted and is expected to be available in December 1993.

.54 The HEAA requires each servicer, lender, or guarantor to have a compliance audit at least annually in accordance with Government Auditing Standards and as prescribed in regulations by the Secretary of Education.

The new audit requirements are not effective until the Department of Education issues implementing regulations; proposed regulations are expected to be issued for comment with final regulations to be issued next spring. New audit requirements for lenders, guarantors, and FFELP servicers applying for "exceptional performer" designation are also not effective until the regulations are issued.

Audit Issues and Developments

FDIC Improvement Act

.55 *Reporting on Multitiered Entities.* Guideline 4(c) contained in 12 CFR Part 363 permits management to make an assertion about the financial reporting controls of more than one of its subsidiary institutions within the scope of 12 CFR Part 363 (a covered subsidiary). However, the auditor's report should relate to an assertion about the financial reporting controls of either (1) a holding company and all subsidiary institutions, or (2) a covered subsidiary. That is, the auditor's report should not relate to combined assertions of more than one covered subsidiary unless both subsidiaries are part of a consolidated group and the auditor is reporting on the holding company and all subsidiaries (both covered and not covered).

.56 *Reporting of Procedures Performed on Internal Auditor's Workpapers.* If, in addition to performing the Section I procedures set forth in 12 CFR Part 363, the auditor applies procedures to internal auditor's workpapers, the following language should be provided in a separate report or included in the Section I attestation report:

Report of Auditors on General Auditor's Assertion Relating to Internal Audit Procedures on Compliance With FDIC-Designated Safety and Soundness Laws and Regulations

To the Board of Directors
XYZ National Bank

We have performed the procedures enumerated below, which were agreed to by XYZ National Bank (the Company) and the Federal Deposit Insurance Corporation (FDIC), solely to assist them in evaluating the Company's [*title of asserter—for example, General Auditor's*] assertion, included in its representation letter dated January 31, 19X4, that: (i) the Company's Internal Audit Department (Internal Audit) performed the procedures listed in Section I of Schedule A of Appendix A to Part 363, Chapter III, Title 12, Code of Federal Regulations, on each of the Company's covered subsidiary banks over $500 million; (ii) Internal Audit tested a sufficient number of transactions governed by the laws and regulations designated under § 363.2, Guideline 12, so that the testing is representative of the Company's volume of transactions; (iii) the workpapers prepared as a result of the procedures performed accurately reflect the work performed and the workpapers are complete; and (iv) a report, which describes the procedures performed and the related findings, has been presented to the Company's audit committee. The sufficiency of the procedures presented below is solely the responsibility of the specified users of the report. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose.

Procedures and Findings

1. We compared Internal Audit's workpapers to the procedures required to be performed under Section I. We did not note any required procedures that were not documented in Internal Audit's workpapers.

2. We compared Internal Audit's sample sizes to the following criteria, to which the FDIC did not object, and found them to be in agreement:

Population Number (N)	*Sample Size*
100 or greater	60
50 to 100	25
0 to 50	*N* or 20, whichever is smaller

3. We compared errors and exceptions listed in Internal Audit's report to the Company's audit committee to those in Internal Audit's workpapers. All such errors or exceptions documented in the workpapers were included in the report.

These agreed-upon procedures are substantially less in scope than an examination, the objective of which is the expression of an opinion on the Company's General Auditor's assertions identified in the first paragraph. Accordingly, we do not express such an opinion. Additionally, we provide no assurance that the procedures described in the Internal Audit's workpapers were effectively carried out or that all error or exception conditions were identified and recorded in the working papers or communicated to the Audit Committee. Furthermore, we did not perform procedures related to the Company's [*title of asserter—for example, General Auditor's*] aforementioned assertion that the workpapers prepared as a result of the procedures performed accurately reflect the work performed and the workpapers are complete. Had we performed additional procedures or had we made an examination of the Company's [*title of asserter—for example, General Auditor's*] assertions identified in the first paragraph, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information of the audit committee, management, and the parties listed in the first paragraph, and should not be used by those who did not participate in determining the procedures.

.57 *Scope of Financial Reporting.* Section 36 requires management to include in its annual report a written assertion about the effectiveness of the institution's internal control structure over financial reporting as of the end of the institution's fiscal year.

.58 Final implementing regulations and guidelines for Section 36 offer no guidance about whether management should consider Call Reports or TFRs for the purposes of reporting under Section 36. When developed, SSAE No. 2 (AT section 400) did not contemplate inclusion of controls over call reporting as part of the internal control structure over financial reporting. Some institutions have held that considering Call Reports or TFRs within the scope of management's assertion (and the related independent accountant's attestation) will be burdensome and costly. However, the staff of the FDIC has stated that management's assertion is expected to consider Call Reports or TFRs within the scope of financial reporting controls addressed by management's assertion.

.59 *Management assertions.* Because of the differing views (discussed above) over the inclusion of call reporting, it is preferable that management's report specify the scope of financial reporting about which management is making its assertions.

.60 *Example A—Management report in which scope is financial reporting in conformity with GAAP and Call Report (or TFR) instructions:*

Internal Control Structure Over Financial Reporting

Management is responsible for establishing and maintaining an effective internal control structure over financial reporting presented in conformity with both generally accepted accounting principles and the Federal Financial Institutions Examination Council instructions for Consolidated Reports of Condition and Income (call report instructions) [or, *Office of Thrift Supervision instructions for Thrift Financial Reports (TFR instructions)*]. The structure contains monitoring mechanisms, and actions are taken to correct deficiencies identified.

There are inherent limitations in the effectiveness of any structure of internal control, including the possibility of human error and the circumvention or overriding of controls. Accordingly, even an effective internal control structure can provide only reasonable assurance with respect to financial statement preparation. Further, because of changes in conditions, the effectiveness of an internal control structure may vary over time.

Management assessed the institution's internal control structure over financial reporting presented in conformity with both generally accepted accounting principles as of December 31, 19XX. This assessment was based on criteria for effective internal control over financial reporting described in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this assessment, management believes that, as of December 31, 19XX, XYZ National Bank maintained an effective internal control structure over financial reporting presented in conformity with both generally accepted accounting principles and call report [or *TFR*] instructions.

.61 *Example B—Management report in which scope is financial reporting in conformity with GAAP:*

Internal Control Structure Over Financial Reporting

Management is responsible for establishing and maintaining an effective internal control structure over financial reporting presented in conformity with generally accepted accounting principles. The structure contains monitoring mechanisms, and actions are taken to correct deficiencies identified.

There are inherent limitations in the effectiveness of any structure of internal control, including the possibility of human error and the circumvention or overriding of controls. Accordingly, even an effective internal control structure can provide only reasonable assurance with respect to financial statement preparation. Further, because of changes in conditions, the effectiveness of an internal control structure may vary over time.

Management assessed the institution's internal control structure over financial reporting presented in conformity with generally accepted accounting principles as of December 31, 19XX. This assessment was based on criteria for effective internal control over financial reporting described in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this assessment, management believes that, as of December 31, 19XX, XYZ National Bank maintained an effective internal control structure over financial reporting presented in conformity with generally accepted accounting principles.

.62 *Attestation reports.* The FDICIA requires that, with respect to any internal control report required of management, the independent accountant shall attest to and report on management's assertions contained in the report.

.63 *Standard independent accountant's report.* Following is an illustrative independent accountant's report (following SSAE No. 2 [AT section 400]) for use with either of the management assertions presented as examples A and B above.

Independent Accountant's Report

[*Introductory paragraph*]

We have examined management's assertion [*describe management's assertion as in example A or B*] as of December 31, 19XX, included in the accompanying [*title of management report*].

[*Scope paragraph*]

Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of the internal control structure over financial reporting, testing, and evaluating the design and operating effectiveness of the internal control structure, and such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

[*Inherent limitations paragraph*]

Because of inherent limitations in any internal control structure, errors or irregularities may occur and not be detected. Also, projections of any evaluation of the internal control structure over financial reporting to future periods are subject to the risk that the internal control structure may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Opinion paragraph*]

In our opinion, management's assertion [*describe management's assertion as in example A or B*] as of December 31, 19XX, is fairly stated, in all material respects, based on *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

.64 If management's assertion does not specify the scope of financial reporting about which management is making its assertion, the independent accountant should ascertain the scope of management's assertion and discuss with management the preferability of its assertion being explicit as to scope. If management's assertion is not explicit, the accountant's attestation report should describe the scope of management's assertion according to the following example:

Independent Accountant's Report

[*Introductory paragraph*]

We have examined management's assertion that XYZ National Bank maintained an effective internal control structure over financial reporting. Management has informed us that the scope of their assertion includes financial reporting presented in conformity with [*both*] generally accepted accounting principles [*and Federal Financial institutions Examination Council Instructions for Consolidated Reports of Condition and Income*; or, *and Office of Thrift Supervision instructions for Thrift Financial Reports*].

[*Standard scope and inherent limitations paragraphs*]

[*Opinion paragraph*]

In our opinion, management's assertion that XYZ National Bank maintained an effective internal control structure over financial reporting as of December 31, 19XX (as described above) is fairly stated, in all material respects, based on *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

.65 *Reports on limited engagements.* In certain cases, management might issue a report similar to that in Example A above (the scope of which includes financial reporting presented in conformity with both GAAP and Call Report or TFR instructions) but might engage the independent accountant only to attest to the assertion as it relates to financial reporting in conformity with GAAP. In such cases, the independent accountant's report should address the limited reporting objective and disclaim an opinion on that portion of management's assertion about the institution's internal control structure over financial reporting presented in conformity with Call Report or TFR instructions.

.66 Following is an example of an explanatory paragraph that should be included in a report issued in these circumstances (or in similar circumstances where management's assertion is not explicit as to its scope):

Independent Accountant's Report

[*Introductory paragraph*]

We have examined management's assertion (included in the accompanying [*title of management report*]) that, as of December 31, 19XX, XYZ National Bank maintained an effective internal control structure over financial reporting presented in conformity with generally accepted accounting principles.

[*Standard scope and inherent limitations paragraphs*]

[*Explanatory paragraph*]

We were not engaged to examine management's assertion as it relates to the internal control structure over financial reporting presented in conformity with the Federal Financial Institutions Examination Council instructions for Consolidated Reports of Condition and Income [or *Office of Thrift Supervision instructions for Thrift Financial Reports*]. Accordingly, we do not express an opinion on that assertion.

[*Opinion paragraph*]

In our opinion, management's assertion that, as of December 31, 19XX, XYZ National Bank maintained an effective internal control structure over financial reporting presented in conformity with generally accepted accounting principles is fairly stated, in all material respects, based on *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

.67 *Safeguarding of Assets.* SSAE No. 2 (AT section 400) addresses "safeguarding of assets," as required by guideline 9.[1] Management's assertion about, and the independent accountant's tests of, financial reporting controls will consider "safeguarding of assets" policies and procedures accordingly. The independent accountant's tests of controls over financial reporting of loans, for example, should include tests of whether the institution is executing transactions in accordance with management's policies for loan underwriting and loan documentation. Such procedures might include, for example, comparing approvals for loan transactions to management's written policy to ascertain whether the loan was approved by an officer or committee consistent with the authority limits specified for that officer or committee in the policy.

.68 Therefore, such policies and procedures are implicit in management's assertion (as illustrated in examples A and B above) and the related independent accountant's opinion.

.69 If, as an integral part of its assertion about the institution's internal control structure over financial reporting, management includes an assertion about safeguarding of assets that goes beyond (for example, to assess the adequacy of management's policies and procedures or its business decisions) the context discussed in paragraph 27 of SSAE No. 2 (AT section 400.27), the independent accountant's report should disclaim an opinion on any assertion that goes beyond the context discussed in paragraph 27 of SSAE No. 2 (AT section 400.27).

Derivatives and Other Potentially High-Risk Investments

.70 In recent years, there has been a growing use of innovative financial instruments that often are very complex and can involve a substantial risk of loss. Users and issuers of such instruments must have the expertise necessary to understand and manage the related risks. As discussed below, auditors should also be familiar with such instruments and the associated risks. One class of these instruments—derivatives—requires particular attention.

.71 Derivatives are complex financial instruments whose values depend on the values of one or more underlying assets or financial indexes. Derivatives generally fall into at least two categories:

1. Asset-backed securities, which include mortgage-backed securities, interest-only and principal-only strips, and tranches of collateralized mortgage obligations
2. Off-balance-sheet instruments such as forward contracts, interest-rate and currency swaps, futures, options, and other financial contracts

By reconfiguring cash flows associated with underlying assets, an issuer can create asset-backed securities that meet the needs of and are attractive to various potential users by isolating, enhancing, or diluting one or more of credit, liquidity, interest-rate, and other risks inherent in the underlying cash flows. For example, through mortgage-backed securities, the issuer can enhance the marketability of underlying mortgage loans by spreading liquidity and credit risk across broad pools, or by providing a higher yield to those users willing to accept a higher concentration of the risks associated with specific collateral cash flows. Similarly, users find certain derivatives

[1] Specifically, paragraph 27 of SSAE No. 2 (AT section 400.27) states:

> In the context of an entity's internal control structure, safeguarding of assets refers only to protection against loss from errors and irregularities in the processing of transactions and the handling of related assets. It does not include, for example, loss of assets arising from management's operating decisions, such as selling a product that proves to be unprofitable, incurring expenditures for equipment or material that proves to be unnecessary or unsatisfactory, authorizing what proves to be unproductive research or ineffective advertising, or accepting some level of merchandise pilferage by customers as part of operating a retail business.

See also appendix D of SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AU section 319.69).

attractive because they can purchase the risks and rewards they desire most, or can synthetically create a security with the desired risk and reward characteristics.

.72 Increased volatility of interest rates, foreign exchange rates, and commodity and other prices, has also fostered tremendous innovation in financial products to meet the needs of users attempting to hedge or alter the related risks. Swaps, for example, are financial contracts in which two parties exchange streams of payments over a period of time. An entity with debt that carries variable interest rates (such as a bank that has short-term certificates of deposit) might swap interest-rate payments on an agreed-upon principal amount with a counterparty by paying a fixed rate and receiving a variable rate. The first entity locks into an interest rate for the term of the swap, reducing the risk that increases in interest rates will increase the entity's cost of funds as its liabilities are refunded or related interest rates are reset. The entity takes on other risks, however, such as the risk that the counterparty could default on its payments. By locking into fixed rates, the entity will no longer benefit from interest-rate decreases during the term of the swap, and it is often costly to terminate a swap. Further, the fair value of derivatives can be volatile in periods of changing market conditions.

.73 *Accounting.* Accounting for derivatives is complex. Given the constant innovation and complexity of derivatives, accounting literature does not explicitly cover some derivatives, however, several related projects are underway.

.74 The FASB has been carrying out a major project on the recognition and measurement of financial instruments, which has already resulted in the issuance of FASB Statements No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (AC F25), No. 107, *Disclosures about Fair Values of Financial Instruments* (AC F25), and No. 115, *Accounting for Investments in Certain Debt and Equity Securities* (AC I80), and FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts* (AC B10), that address related issues. The FASB's project includes a comprehensive review of accounting for hedging and risk-adjusting derivatives. Also, the International Accounting Standards Committee is in the process of developing an international accounting standard for financial instruments.

.75 Several accounting issues involving derivatives have also been addressed by the FASB's Emerging Issues Task Force (EITF). Other guidance is provided by FASB Statements No. 52, *Foreign Currency Translation* (AC F60) and No. 80, *Accounting for Futures Contracts* (AC F80). In addition, AICPA Issues Paper No. 86-2, *Accounting for Options,* discusses various matters related to options.

.76 *Auditing.* The innovative and complex nature of such investment vehicles may significantly increase audit risk. For example, as more and more financial institutions enter the markets for such instruments, their profitability may diminish. Traders may attempt to compensate for the diminution by increasing the volume of transactions involving such instruments or by further customizing products. An increase in volume may be accompanied by trading with counterparties that have higher credit risk. Customizing transactions may increase valuation difficulties. The propriety of the methods used by the managements of banks and savings institutions to account for transactions involving sophisticated financial instruments and to determine their value should be carefully considered. Understanding the substance of transactions in such instruments is important in determining the propriety of their accounting treatment. In some circumstances, auditors may find it helpful to consult with experts.

.77 SAS No. 22 (AU section 311) requires that auditors understand the events, transactions, and practices that, in their judgment, may have a significant effect on the financial statements. Accordingly, auditors should carefully consider the various risks involved with investments in derivatives and other complex securities as they plan their audits and should—

- Assess the level of management's expertise in monitoring, evaluating, and accounting for the securities.
- Ensure that the entity has set appropriate policies and procedures for investment in high-risk securities and that there is adequate oversight by the board of directors.

- Involve specialists, when necessary, in valuing and auditing these investments.

The Audit and Accounting Guide *Audits of Savings Institutions* and the Industry Audit Guide *Audits of Banks,* provide additional information on the credit, liquidity, interest-rate, and other risks associated with financial instruments and related internal control structure considerations.

SEC Actions

.78 Discussed below are several SEC Accounting and Auditing Enforcement Releases (AAERs) that have been issued since September 1992 and that involve banks and savings institutions and auditors of their financial statements. Readers should further consult the cited AAERs for the specific circumstances in each instance.

.79 *Credit Losses.* Several AAERs have been issued concerning nontimely recognition of losses, including failure to provide loss reserves that are adequate to absorb probable losses in the loan and real estate portfolios; failure to correctly value in-substance foreclosures of real estate; and failure to record losses on foreclosed assets in a timely manner (AAERs 432, 471, and 472).

.80 *Auditor Independence.* In one instance, the audit engagement partner for a financial institution maintained unsecured loans from the institution at the time of the audit that were clearly material to his net worth. Subsequent to January 1, 1992, interpretations of AICPA independence rules (as set forth in ET section 101.07) prohibit all loans from financial institution clients except automobile loans and leases, credit card and cash-advance balances that do not in the aggregate exceed $5,000, loans on the cash surrender value of life insurance policies, and loans collateralized by cash deposits (passbook loans). Loans permitted under previous ethics interpretations were grandfathered; however, the value of collateral on a secured loan must equal or exceed the remaining balance of the loan at January 1, 1992, and at all times thereafter (AAER 437).

.81 *Intentional Misstatements.* In two AAERs, registrants improperly accelerated revenue and deferred costs through intentional errors, including reclassification of current expenses as prepaid assets; accrual of fee income on trust accounts in amounts greater than those supported by the market value of the assets in those accounts; recognition of the loss on mandatory conversion of preferred stock over several years rather than immediately; recognition of income from loan fees immediately rather than as a yield adjustment; correction of routine accounting errors over a period of months rather than immediately; and failure to accrue expenses as incurred and recognition of income on real estate transactions that was not earned (AAERs 426 and 439).

.82 *Inadequate Controls Over Surprise Cash Count.* In one instance, an auditor failed to maintain appropriate controls during a surprise cash count to prevent concealment of a large cash shortage by substitution of cash from other locations. The auditor also failed to sufficiently investigate management's explanations of a large reconciling item on the vault general ledger proof sheet (AAER 458).

.83 *Real Estate Transactions.* In several AAERs, gains were recognized on real estate transactions when criteria of FASB Statement No. 66 (AC Re1) and Accounting Principles Board Opinion (APB) No. 29, *Accounting for Nonmonetary Transactions* (AC N35), had not been met. In one transaction, the selling institution provided the funds for the down payment to the buyer in contravention of the requirements of FASB Statement No. 66 (AC Re1). Another transaction involved the simultaneous purchase and sale of land between an institution and a real estate developer which should have been accounted for as a nonmonetary transaction under APB Opinion No. 29 [AC N35] (AAERs 461, 462, 471, and 472).

.84 *Accounting Change.* In two AAERs, to avoid recognition of additional losses, institutions improperly changed their method of accounting for a real estate investment from the equity to the cost method without a supporting change in circumstances (AAERs 461 and 462).

.85 *Loss Contingencies.* The SEC issued Staff Accounting Bulletin (SAB) No. 92, *Accounting and Disclosures Relating to Loss Contingencies,* which expresses certain staff views about accounting and disclosure related to loss contingencies, including environmental liabilities. The guidance is intended to promote timely recognition of loss contingencies and address the diversity in practice on matters such as offsetting probable recoveries against probable contingent liabilities, recognition of liability for costs apportioned to other potential responsible parties, uncertainties in estimation of the extent of environmental liability, the appropriate discount rate for environmental liabilities, whether discounting is appropriate, accounting for exit costs, disclosures, and other issues.

.86 *Segment Disclosures.* The SEC staff has viewed increasing volumes of fee-based activities at certain institutions to be an expansion of services beyond traditional banking activities. Accordingly, the SEC staff has asserted that institutions may now be operating in different industry segments as defined by FASB Statement No. 14, *Financial Reporting for Segments of a Business Enterprise* (AC S20). The SEC staff believes that, if an institution has substantial amounts of revenue from fee-based or other service areas such as mortgage banking, trust, credit card, mutual fund, capital market, or processing businesses, it should consider whether any related disclosures required by FASB Statement No. 14 (AC S20) have been appropriately addressed.

.87 *Industry Guide 3.* The SEC is working on revisions of its guide for disclosures by banks and savings institutions in public filings. Readers should be alert for any final changes in the required disclosures and their effect on disclosure by publicly held institutions.

Noncompliance With Capital Adequacy and Other Regulatory Requirements

.88 Events of noncompliance with regulatory requirements, such as failure to meet minimum capital requirements or participation in impermissible activities or investments, expose depository institutions to regulatory action. Events of noncompliance may be brought to the auditor's attention during the application of normal auditing procedures, during the review of regulatory examination reports, or as a result of actions required by regulators.

.89 SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU section 341), states that "the auditor has a responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited." Noncompliance or expected noncompliance with regulatory capital requirements is a condition, when considered with other factors, that could indicate substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. Other factors that should be evaluated are identified in SAS No. 59 (AU section 341).

Asset Quality and Valuation Issues

.90 Credit quality and other asset quality issues associated with commercial and consumer loans, real estate portfolios, troubled debt restructurings, foreclosures and in-substance foreclosures, off-balance-sheet financial instruments, and other assets, require critical attention in audits of the financial statements of banks and savings institutions. Auditors should obtain reasonable assurance that management has recorded adequate asset valuation allowances and liabilities for other credit exposures based on all relevant factors. The subjectivity of determining asset valuation allowances, combined with continued economic uncertainty, reinforces the need for careful planning and execution of audit procedures in this area.

.91 Lack of an asset impairment evaluation system or failure of an institution to document adequately its criteria and methods for determining asset valuation allowances may indicate a material weakness in the institution's internal control structure, and will generally increase the extent of judgment that must be applied by both regulatory examiners and auditors in evaluating the adequacy of management's allowances, and will increase the likelihood that differences will result. The guidance in SAS No. 57, *Auditing Accounting Estimates* (AU section 342), should be followed in auditing asset valuation allowances. Other sources of information on auditing loan loss allowances include the AICPA Industry Audit Guide *Audits of Banks,* the Audit and Accounting Guide *Audits of Savings Institutions* and the Auditing Procedure Study *Auditing the Allowance for Credit Losses of*

Banks. The Audit and Accounting Guide *Guide for the Use of Real Estate Appraisal Information* provides guidance to help auditors understand real estate appraisal concepts and information.

.92 As with credit risk, other valuation issues involve many subjective assumptions. For example, the expected effects of prepayments on loans in portfolios and the types of income and expense items included in valuations of loan servicing assets have a significant impact on the recorded values of those assets. High levels of prepayments of mortgage loans, for example, have resulted in impairment of many assets, such as purchased mortgage servicing receivables and interest-only securities. Evaluation and recognition of impairment due to prepayments should include consideration of the institution's aggregation policy, discount rates, and assumptions about future prepayment rates.

.93 Further, falling interest rates have created an environment in which transactions involving gains trading of securities, refinancing of loans, restructuring of nonperforming assets, origination of loans to facilitate the sale of real estate owned, and other asset dispositions all require specific attention. Such transactions require an understanding of the specific situations so that the auditor may carefully assess and control audit risk.

Mortgage Banking Engagements

.94 Auditors who are engaged to report on mortgage banking activities of banks and savings institutions should be aware of the following developments.

.95 *MBA USAP.* The Mortgage Bankers Association of America (MBA) is revising its Uniform Single Audit Program for Mortgage Bankers (USAP). The program was introduced in 1965 and has gained acceptance by investors as a useful guide for engagements that address the servicing functions of mortgage banking entities. Since the last USAP revision in 1983, changes in auditing standards have redefined the nature and reporting requirements of similar engagements. The MBA is considering revising the USAP as an examination level engagement under the AICPA's Attestation Standards. However, pending completion of the USAP revision, the MBA has suggested that entities follow the reporting and other requirements of the 1983 USAP.

.96 SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AU section 324), provides guidance to auditors of service organizations (such as loan servicers) on reporting on certain aspects of the service organizations' internal control structures that can be used by other auditors, and also provides guidance on how other auditors should use such reports.

.97 *Freddie Mac.* The Federal Home Loan Mortgage Corporation (Freddie Mac) issued a revised *Compliance Reporting Guide* that supersedes its previous guide issued in June 1991. The revised guide addresses the scope of compliance attestation engagements at entities that sell or service mortgage loans under Freddie Mac programs, sets forth certain procedures to be performed, and presents required reporting formats.

.98 The Freddie Mac guide includes an agreed-upon-procedures-level attestation engagement to be performed on the seller/servicer's assertions about its compliance with Freddie Mac eligibility requirements and is effective for reporting on periods ending June 30, 1993 and thereafter. Seller/servicers were given copies of the guide with instructions to provide copies to their auditors.

Accounting Developments

FASB Financial Instruments Project

.99 The FASB's agenda continues to include a project on financial instruments that encompasses three primary segments: disclosures, distinguishing between liabilities and equity, and recognition and measurement. In addition to these three primary segments, the FASB has addressed several narrower issues within the overall scope of the project. Some of the current developments of the project are described in the following sections.

.100 *Impairment of a Loan.* In May 1993, the FASB issued FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan* (AC I08), which addresses the accounting by creditors for impairment of certain loans. The Statement is applicable to all creditors and to all loans, uncollateralized as well as collateralized, except large groups of smaller-balance homogeneous loans that are collectively valued for impairment, loans that are measured at fair value or at the lower of cost or fair value, leases, and debt securities as defined in FASB Statement No. 115 (AC I80). It applies to all loans that are restructured in a troubled debt restructuring involving a modification of terms.

.101 FASB Statement No. 114 (AC I08) requires that impaired loans that are within its scope be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or as a practical expedient, at the loan's observable market price or the fair value of collateral if the loan is collateral dependent.

.102 The Statement amends FASB Statement No. 5, *Accounting for Loss Contingencies* (AC C59), to clarify that a creditor should evaluate the collectibility of both contractual interest and contractual principal of all receivables when assessing the need for a loss accrual. The Statement also amends FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings* (AC D22), to require a creditor to measure all loans that are restructured in a troubled debt restructuring involving a modification of terms in accordance with its provisions.

.103 The Statement applies to financial statements for fiscal years beginning after December 15, 1994. Earlier application is encouraged.

.104 Sources of guidance relevant to auditing loan loss allowances are described in paragraph .91.

.105 Some banks and savings institutions may adopt the provisions of the Statement prior to its effective date. Auditors of the financial statements of such banks and savings institutions should carefully consider the implications of applying the new provisions of the Statement on audit risk. Aspects of applying the new Statement that warrant particular consideration include—

- Proper identification of all loans to which the Statement should be applied.
- The reasonableness of estimates of future cash flows and interest rates used in discounting.
- The appropriateness of amounts used to measure impairment if alternatives to present value amounts, such as fair values of collateral or observable market prices, are used.
- The relationship between the identification of impaired loans under the Statement and the classification of loans under regulatory classification systems.
- The presentation of accrued interest receivable and its relationship to valuation allowances.
- The relevance of concepts of performing and nonperforming assets.

.106 *Investments in Debt and Equity Securities.* In May 1993, the FASB issued FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (AC I80), which addresses the accounting and reporting for investments in equity securities that have readily determinable fair values (previously addressed by FASB Statement No. 12, *Accounting for Certain Marketable Equity Securities* [AC I89]) and for all investments in debt securities. FASB Statement No. 115 (AC I80) does not cover securities accounted for by the equity method and investments in consolidated subsidiaries. FASB Statement No. 115 (AC I80) establishes three categories of reporting debt and marketable equity securities:

- Held-to-maturity securities (debt securities that the bank or savings institution has the positive intent and ability to hold to maturity), to be reported at amortized cost

- Trading securities (debt and equity securities that are bought and held principally for the purpose of selling them in the near future), to be reported at fair value, with unrealized gains and losses included in earnings

- Available-for-sale securities (debt and equity securities not classified as either held-to-maturity or trading), to be reported at fair value, with unrealized gains and losses excluded from earnings and reported in a separate component of equity until realized

Mortgage-backed securities that are held for sale in conjunction with mortgage banking activities (as described in FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities* [AC Mo4]), are classified as trading securities. Mortgage-backed securities that are currently not held-for-sale in conjunction with mortgage banking activities may be classified in one of the two other categories, as appropriate.

.107 FASB Statement No. 115 (AC I80) also requires banks and savings institutions to determine whether declines in the fair value of individual securities classified as either held-to-maturity or available-for-sale below their amortized cost bases are other than temporary. For example, if it is probable that an investor will be unable to collect all amounts due according to the contractual terms of a debt security not impaired at acquisition, an other-than-temporary impairment is considered to have occurred. If such a decline is judged to be other than temporary, the cost basis of the individual security should be written down to fair value as the new cost basis, with the amount of the write-down included in earnings (that is, accounted for as a realized loss).

.108 The Statement also specifies the accounting treatment for transfers between categories.

.109 The Statement (paragraph 8 [AC I80.105]) indicates that certain changes in circumstances may cause the enterprise to change its intent to hold a certain security to maturity without calling into question its intent to hold other debt securities to maturity in the future. Such circumstances include evidence of a significant deterioration in the issuer's creditworthiness or a change in tax law that eliminates or reduces the tax-exempt status of interest on the debt security. In addition, other events that are isolated, nonrecurring, and unusual for the reporting enterprise that could not have been reasonably anticipated may cause an enterprise to sell or transfer a held-to-maturity security without necessarily calling into question its intent to hold other debt securities to maturity. Such sales and transfers of held-to-maturity securities are expected to be rare.

.110 An entity shall not classify a debt security as held-to-maturity if it has the intent to hold the security for only an indefinite period. Consequently, a debt security should not, for example, be classified as held-to-maturity if the enterprise anticipates that the security would be available to be sold in response to changes in market interest rates and related changes in the security's prepayment risk, needs for liquidity, changes in the availability of and the yield on alternative investments, changes in funding sources and terms, and changes in foreign-currency risk.

.111 FASB Statement No. 115 (AC I80) is effective for fiscal years beginning after December 15, 1993. It specifically prohibits retroactive restatement of prior financial statements. Although typically FASB Statement No. 115 (AC I80) would be initially applied as of the beginning of a fiscal year (such as January 1, 1994), entities are permitted to initially apply the Statement as of the end of an earlier annual period for which financial statements have not been issued (with no restatement of interim periods).

.112 Since all banks and savings institutions with a calendar fiscal year must classify their investments in securities in accordance with FASB Statement No. 115 (AC I80) as of January 1, 1994, those banks and savings institutions will also be able to apply the Statement as of December 31, 1993, if they wish to do so in their 1993 annual financial statements. Thus, auditors should be aware of some of the issues that are likely to arise when the Statement is applied. Auditing financial statements involving the classification of investments in debt and equity securities pursuant to FASB Statement No. 115 (AC I80) may involve a high degree of judgment about such matters as the following:

- How auditors should evaluate subjective exceptions for sales of securities designated as held-to-maturity (including the interpretation of restrictive terms such as *isolated, nonrecurring,* and *unusual*)
- How auditors should evaluate the ability of a bank or savings institution to hold securities to maturity, particularly when going-concern issues arise
- Whether cash flow projections are needed in conjunction with assessing a bank's or savings institution's ability to hold securities to maturity
- How to evaluate whether impairments of investments are other than temporary

Auditors of the financial statements of publicly held institutions should also consider the guidance of SEC SAB No. 74, *Disclosures Regarding Accounting Standards Issued But Not Yet Adopted.*

.113 The Omnibus Budget Reconciliation Act of 1993 included a provision requiring securities dealers to compute their taxable income by marking their inventory of securities to market at the end of each taxable year. The definition of securities dealer appears to encompass many banks and savings institutions that buy and sell securities. Subject institutions must generally identify securities exempt from the mark-to-market provision at acquisition. Identification of securities held at August 10, 1993 (the date of enactment) or acquired between August 10, 1993, and October 31, 1993, may be made by October 31, 1993.

.114 The identification of securities for tax purposes under this provision is not equivalent to the nature and purpose of management's classification of investments in certain debt and equity securities under GAAP (including application of FASB Statement No. 115 (AC I80)). However, for those securities subject to the provisions of FASB Statement No. 115 (AC I80), the auditor should consider whether management's identification of securities for tax purposes contradicts its stated intent for GAAP.

Consensus Decisions of the FASB's EITF

.115 The FASB's EITF frequently discusses accounting issues involving financial instruments, real estate, or transactions of similar importance to banks and savings institutions.

.116 In EITF Issue No. 93-5, *Accounting for Environmental Liabilities,* the EITF reached a consensus that, among other things, an environmental liability should be evaluated independently from any potential recovery and that the loss arising from the recognition of an environmental liability should be reduced only when a claim for recovery is probable of realization.

.117 In EITF Issue No. 93-1, *Accounting for Individual Credit Card Acquisitions,* the EITF reached a consensus that credit card accounts acquired individually should be accounted for as originations under FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases* (AC L20), and EITF Issue No. 92-5 (see the following discussion).

.118 In EITF Issue No. 92-10, *Loan Acquisitions Involving Table Funding Arrangements,* the EITF reached a consensus that a mortgage loan acquired by a mortgage banking enterprise in a table funding arrangement should be accounted for as a purchase of the loan if the loan is legally structured as an origination by the correspondent and if the correspondent is independent of the mortgage banking enterprise. If any criterion set forth in the consensus is not met, the loan should be accounted for by the mortgage banking enterprise as an originated loan.

.119 In EITF Issue No. 92-5, *Amortization Period for Net Deferred Credit Card Origination Costs,* the EITF reached a consensus that credit card origination costs that qualify for deferral pursuant to paragraph 6 of FASB Statement No. 91 (AC L20.105) should be netted against the related credit card fee, if any, and the net amount should be amortized on a straight-line basis over the privilege period. If a significant fee (relative to the related costs) is charged, the privilege period is the period that the fee entitles the cardholder to use the card. If there is no significant fee, the privilege period should be one year.

.120 In addition, the EITF reached a consensus that for both purchased and originated credit cards, an entity should disclose its accounting policy, the net amount capitalized at the balance sheet date, and the amortization period(s) of credit card fees and costs.

.121 In EITF Issue No. 92-2, *Measuring Loss Accruals by Transferors for Transfers of Receivables with Recourse,* the EITF reached a consensus that the obligation recorded at the date of sale in connection with the recourse provisions of a transfer of receivables should include all probable losses over the life of the receivables transferred and not only those measured and recognized in conformity with FASB Statement No. 5 (AC C59) prior to the date of transfer. The EITF also reached a consensus that recognition of the recourse obligation on a present value basis, as defined, would be acceptable if the timing of the cash flows can be reasonably estimated. The SEC Observer also offered views on netting and discount rates.

.122 At a September 23, 1993 meeting of the EITF, the SEC Observer made announcements about implementation of FASB Statements No. 114 (AC I08) and No. 115 (AC I80).

.123 The SEC Observer stated that Financial Reporting Release (FRR) 28, *Accounting for Loan Losses by Registrants Engaged in Lending Activities,* requires that in-substance foreclosed (ISF) assets be classified and accounted for as "other real estate owned" (OREO or REO). He also noted that, on June 10, 1993, the banking regulators jointly issued a regulatory credit initiative that is not consistent with the guidance provided in FRR 28 because the regulatory initiative permits the classification of ISF assets as loans rather than an OREO or REO. The SEC Observer said that registrants have asked whether the SEC staff would object to the classification of ISF assets as loans in financial statements and other financial information filed with the SEC.

.124 Even though the classification of ISF assets as loans is not consistent with the guidance contained in FRR 28, the SEC Observer stated that it is the position of the SEC staff that the main objective of FRR 28 is to require a systematic methodology to be applied to the recognition and measurement of ISF assets, and that this objective should be met even if the classification pursuant to the regulatory credit initiative is adopted by registrants. Therefore, the SEC staff would not object to the reclassification of ISF assets as loans, provided—

1. Registrants do not change their recognition and measurement accounting policies for ISF assets.

2. Registrants file with the SEC, in a current report, financial statements and other financial information, including Guide 3 disclosures and Management's Discussion and Analysis, that reflect the effects of the new classification policy for ISF assets for each period for which such statements and other financial information were provided in the most recent 10-K and subsequent interim reports. This means that registrants should present the impact of the new reclassification policy on (*a*) the financial statements for each of the latest three years, (*b*) each quarterly period since the last Form 10-K as well as comparable quarters for the preceding fiscal year, and (*c*) all other financial information, including Guide 3 disclosures and Management's Discussion and Analysis, for each period for which such statements and other financial information were provided.[2]

3. There is disclosure of the reclassification and its effects.

The SEC Observer stated that the SEC staff will object if, because of the adoption of this new regulatory initiative, ISF assets are not classified consistently. Therefore, registrants cannot adopt this initiative on a prospective basis because the financial statements and other financial information would not be presented in a consistent manner.

.125 The SEC Observer noted that FASB Statement No. 115 (AC I80) requires an investment in a security to be classified as held to maturity, available for sale, or trading, based on an enterprise's intent with respect to holding the security. The SEC observer further stated that the SEC staff understands that the anticipated adoption of FASB Statement No. 115 (AC I80) and possible changes in regulatory capital requirements may have caused

[2] The SEC Observer said a current report could, for example, be filed with the SEC using Form 8-K, or alternatively, by amending previously filed documents.

registrants to change their intent with respect to holding certain securities. As a result, for financial reporting purposes, these registrants may need to change their classification of certain securities to reflect that revised intent.

.126 The SEC staff has been asked whether such a change in classification would call into question the prior accounting for securities. The SEC Observer said the staff will not challenge a registrant's prior accounting for securities as a result of a one-time change in the classification of securities on, or prior to, the date of adopting FASB Statement No. 115 (AC I80) if that change is caused by a change in intent because of the anticipated adoption of FASB Statement No. 115 (AC I80) and possible changes in the regulatory capital requirements. Registrants should not, however, change the measurement principles for securities prior to the adoption of FASB Statement No. 115 (AC I80).

Accounting Standards Executive Committee Activities

.127 *Accounting for Foreclosed Assets.* The Accounting Standards Executive Committee (AcSEC) decided to postpone further consideration of the issues addressed in its exposure draft of a proposed statement of position (SOP), *Accounting for the Results of Operations of Foreclosed Assets,* since the FASB decided to address accounting for assets to be disposed of in its project on impairment of long-lived assets. The AcSEC plans to resume its discussions on the exposure draft after the FASB has made decisions on the issues to be addressed in the project.

.128 *Real Estate Investments.* In late 1993, the AcSEC issued an exposure draft of a proposed SOP, *Identifying and Accounting for Investments in Real Estate that Qualify as Investments in Real Estate.* The proposed SOP provides related guidance on such loans, which may include real estate acquisition, development, and construction (ADC) loans, loans on operating real estate, convertible mortgages, and shared appreciation (participating) mortgages. The SOP would require real estate loans that do not meet certain criteria to be classified and accounted for as investments in real estate. A loan that is classified and accounted for as an investment in real estate under the SOP would be considered to be the equivalent of an investment by the lender in a hypothetical partnership, the assets of which include the subject real estate. The SOP is proposed to be applied to real estate loans entered into after December 31, 1994, with earlier application encouraged. A final SOP is expected to be issued in 1994.

Ethics Development

.129 The AICPA Professional Ethics Executive Committee has issued the following interpretation, which relates to outsourcing of internal audit activities by clients, including clients that are banks or thrifts:

Ethics Ruling No. 97—Interpretation of Rule 101:
Performance of Certain Extended Audit Services

> *Question*: A client is considering engaging a member to assist with the performance of its internal audit activities or extend the member's audit services when the client does not maintain an internal audit function. The activities that the member would be engaged to perform could include, among other things, the following: (1) testing the system of internal controls, confirming accounts receivable, and analyzing fluctuations of income and expense accounts; (2) reviewing loan originations or similar activities as part of the client's approval process or internal control system; and (3) reviewing the client's loan origination or other business processes for their functioning, efficiency or effectiveness and providing recommendations to management. Would independence be considered to be impaired if the member performs any of these services?
>
> *Answer*: The performance of activities such as those described in (1) above would not impair independence regardless of whether the member assists in the performance or performs all such activities for the client. The activities described in (1) are generally of the type considered to be extensions of audit procedures to be performed in conducting the annual audit, even though the extent of testing may exceed that required by generally

accepted auditing standards. The performance of the activities in (2) above would impair independence because the member would be performing a management function. The activities described in (3) above, although not generally considered necessary for conducting the annual audit, are services that would not impair independence as long as the member does not perform management functions or make management decisions.

Guidance from the federal banking and thrift regulatory agencies on supervisory matters related to outsourcing of internal audit activities will be forthcoming.

Information Sources

General

.130 Copies of the FDIC Improvement Act (stock number 869-015-00242-6) are available from the Government Printing Office and can be ordered by calling (202) 783-3238 or by FAXing to (202) 512-2250 (VISA or MasterCard charges only; include expiration date). Price: $4.50.

.131 Regulations of the OCC, the FDIC, the FRB, and the OTS are codified in Section 12 CFR.

.132 OCC supervisory policies and guidance are issued as Advisory Letters, Banking and Examining Bulletins and Circulars, Memoranda, updates to the Division of Supervision Manual of Examination Policies, News Releases, updates to the OCC Policies and Procedures Manual, and other issuances. For information on ordering copies of OCC issuances, call OCC Publications Control at (202) 874-4884.

.133 FDIC policy is communicated in Financial Institution Letters, News Releases, Regional Director Memoranda, and in instructions for FFIEC Call Reports. For information about ordering these issuances, call FDIC Corporate Communications at (202) 898-6996.

.134 Information about FRB publications is available through FRB Publications Services, (202) 452-3245.

.135 OTS supervisory policies and guidance are issued in the form of Thrift Bulletins, Regulatory Bulletins, Transmittals, and in guidance provided to examiners through a multivolume set of agency handbooks. For information on ordering OTS publications, call the OTS Controller's Division at (202) 906-6427.

.136 Copies of SEC publications are available through the SEC's public reference room at (202) 272-7450.

.137 For additional copies or information about Freddie Mac's *Compliance Reporting Guide*, contact Freddie Mac at (703) 903-2186.

Derivatives

.138 The November 1989 issue of *Journal of Accountancy* includes several articles on financial instruments issues. Other publications that provide useful information about financial instruments, complex derivatives, and related risks include:

> *Derivative Product Activities of Commercial Banks*, a joint study by federal banking regulators (January 27, 1993). For copies, call FDIC Corporate Communications at the number above.
>
> *A Survey of International Banking,* The Economist (April 10, 1993). For reprints, send $3.50 plus applicable sales tax to The Economist Newspaper Group, Inc., Reprints Department, 111 W. 57th St., New York, NY 10019.
>
> *Recognition and Measurement of Financial Instruments,* a discussion memorandum prepared by the FASB as part of its financial instruments project (No. 109-A, November 18, 1991). A FASB research report, *Hedge Accounting: An Exploratory Study of the Underlying*

Issues (1991) and a staff report on related deliberations and tentative conclusions (July 30, 1993) are also available. For copies, call the FASB Order Department at the number below.

Derivatives: Practices and Principles, an overview of global derivatives (July 1993; $110). To order contact Group of Thirty, 1990 M Street, NW, Washington, DC 20036.

.139 Public-sector studies are also underway by the SEC, the General Accounting Office, and the federal banking regulatory agencies.

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.140 This Audit Risk Alert replaces *Depository Institutions Industry Developments—1992.*

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.141 Auditors should also be aware of the economic, regulatory, and professional developments that may affect the audits they perform, as described in *Audit Risk Alert—1993* [AAM section 8010].

[The next page is 8161.]

AAM Section 8060

Employee Benefit Plans Industry Developments—1994

Industry and Economic Developments

.01 The road to economic recovery appears to hold a number of obstacles that are likely to significantly affect employee benefit plans and their financial statements. Chief among the concerns is the sensitivity of many plans to interest rates and interest rate fluctuations.

The Impact of Interest Rate Fluctuations

.02 *Investment Policy.* As interest rates fell to historically low levels over the past year, a number of pension plan administrators and investment managers adopted increasingly more aggressive investment strategies—directing an increasingly larger proportion of plan investments into higher yielding and frequently higher risk investment vehicles. These investments included derivative products such as futures, options, and swap contracts; securities lending arrangements; so-called junk bonds; real estate and specialized real estate investment securities; and global securities. As the long-awaited economic recovery unfolds and interest rates begin to climb, the quality and value of many of these plan investments may continue to be called into question. In light of the volatility of financial markets, auditors should continue to be particularly sensitive to concerns about the valuation of plan investments and the adequacy of related disclosures. Auditors of plans with significant investments in contracts with financial institutions need to consider the financial stability of the issuing companies (particularly those with significant holdings in high-risk investments) and their ability to fulfill their contractual obligations.

.03 *Funded Status.* Changes in interest rates can also have a significant effect on the funded status of defined benefit pension plans. Lower interest rates may cause plans to decrease assumed rates of return used in actuarial calculations, resulting in increases in the actuarial present value of accumulated plan benefits. As a result, when rates are relatively low, many defined benefit pension plans that historically have been well funded may no longer be so as large increases in the actuarial present value of accumulated plan benefits erode their overfunded status.

.04 Fluctuations in interest rates may prompt plans to reassess the reasonableness of the interest rate assumptions inherent in the actuarial determination of plan data. Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 35, *Accounting and Reporting by Defined Benefit Pension Plans* (AC Pe5), stipulates that assumed rates of return used to determine the actuarial present value of accumulated plan benefits shall reflect the "expected rates of return during the periods for which payment of benefits is expected to be deferred and shall be consistent with returns realistically achievable on the types of assets held by the plan and the plan's investment policy." The Statement also stipulates that expected rates of inflation used in estimating automatic cost-of-living adjustments should be consistent with the assumed rates of return. Auditors should carefully consider whether the rates of return and rates of inflation assumed by the plan's actuaries are reasonable and should question rates that appear to be out of line with those that they believe are realistically achievable. Statement on Auditing Standards (SAS) No. 57, *Auditing Accounting Estimates* (AU section 342), provides auditors with guidance on obtaining and evaluating sufficient competent evidential matter to support significant accounting estimates in audits of financial statements.

.05 *Funding Problems.* Significant underfunding of many defined benefit pension plans is causing increasing concern in both the public and private sectors. Recent estimates indicate that state and local governmental pension plans across the country are underfunded by more than $125 billion, prompting speculation that public pension fund underfunding will be the next century's equivalent of today's "health care crisis." In addition, the funding problems at the Pension Benefit Guaranty Corporation (PBGC) continue to cause concern about its ability to meet its obligation to guarantee benefits under defined benefit pension plans in the private sector. The PBGC's growing deficit coupled with the substantial additional risk of insuring underfunded plans that are sponsored by financially troubled companies are major sources of this concern. Many of the already underfunded plans have granted enhanced pension benefits in conjunction with work force or salary reduction programs, thereby causing them to fall even further behind in funding. There is still speculation that a taxpayer bailout of the PBGC may be necessary. Congress has taken steps to attempt to improve the situation and is currently considering legislation that includes a number of provisions aimed at strengthening the financial condition of underfunded defined benefit pension plans in general, and the PBGC in particular.

.06 *AICPA Recommendations.* Many participants of underfunded defined benefit pension plans do not realize that some or all of their pension benefits may be at risk if the plan sponsor fails. In April 1993, the AICPA submitted to the Labor–Management Relations Subcommittee of the House of Representatives a statement that proposed specific measures to correct a shortfall in the information about their defined benefit pension plans that participants need to help them plan for their retirement. The AICPA recommended the following reforms to improve disclosures to plan participants:

1. The U.S. Department of Labor (DOL) should enhance and expand the information required in the Summary Annual Report to include fundamentals, such as how much the plan has promised to pay participants (in other words, the accumulated plan benefits), whether the plan is currently funded to make good on those commitments, whether plan benefits are insured by the government's PBGC, and the quality of the plan's investments.

2. The DOL should monitor compliance to ensure that plan participants receive the Summary Annual Report.

3. The DOL should ensure that every individual member of multi-employer pension plans (for example, union-sponsored plans) has access to information on how much benefits he or she has earned.

4. The DOL should shorten the time allowed for plans to notify employees of major plan changes to no more than ninety days.

5. The FASB should require that defined benefit pension plans prominently disclose the total accumulated plan benefits in the financial statements.

6. Congress should require pension plans to have full scope audits.

In December 1993, the DOL issued a Request for Information (RFI) intended to assist its evaluation of the extent to which the current disclosure requirements serve to assure that participants and beneficiaries are provided with useful and timely information about their plans and the extent to which the current requirements need to be updated. Auditors should be alert for any regulatory or legislative proposals that may result from the RFI.

Regulatory and Legislative Developments

Regulatory Developments

.07 *PWBA Review of Plan Audits.* During 1993, the DOL Pension and Welfare Benefits Administration (PWBA) continued to implement its quality review program for audits required by the Employee Retirement Income Security Act of 1974 (ERISA). Practitioners deemed by the PWBA to have performed significantly substandard audit work are referred to either state licensing boards or the AICPA Professional Ethics Division for further investigation. As of December 31, 1993, 46 referrals had been made to state licensing boards and 200 referrals had been made to the AICPA Professional Ethics Division; of these the Professional Ethics Division has resolved 148 cases. Of these resolved cases, 49 were referred to the AICPA's Trial Board, 73 resulted in letters of recommended corrective action, nine were found to contain no deficiencies, and 17 were closed for other reasons. Common deficiencies noted in the referrals included—

- Inadequate or no audit program or planning.
- Inadequate or no understanding of the internal control structure.
- Inadequate or no documentation supporting the audit work performed.
- Deficiencies in the auditor's report.
- Deficiencies in the note disclosures.

As part of its quality review program, the PWBA also performs on-site reviews of independent auditor's working papers. As of December 31, 1993, one hundred thirty-five such reviews had been performed. Professional work deemed significantly deficient by the PWBA as a result of its reviews is referred to the AICPA Professional Ethics Division or to appropriate state boards of accountancy. Because ERISA places the responsibility for seeing that plans' financial statements are audited on plan administrators, deficient audit work can expose plan administrators to significant penalties under ERISA section 502(c)(2).

.08 *PWBA Reporting Compliance Program.* In addition to its quality review program for ERISA audits, the PWBA has an aggressive reporting compliance program to ensure that plan administrators comply with ERISA's reporting requirements. Through 1993, the PWBA has rejected over 2,700 filings and imposed over $50 million in civil penalties under ERISA section 502(c)(2), which provides for penalties of up to one thousand dollars per day against plan administrators who fail to file acceptable annual reports on a timely basis.

.09 In December 1992, PWBA concluded a grace period program designed to encourage late filers and nonfilers to submit required annual report filings to the DOL. This program resulted in the submission of over 40,000 additional filings and the collection of approximately 40 million dollars in civil penalties.

.10 The PWBA continues to actively identify and target both late filers and nonfilers. Over 1,400 late filers and nonfilers have been identified and assessed over nine million dollars in late filing and nonfiling penalties.

.11 The PWBA encourages practitioners to urge their clients to file any delinquent annual report filings. The following penalties may be assessed against late filers or nonfilers:

- *Late Filers*—Plan administrators who voluntarily file annual reports for 1988 and subsequent reporting years after the due date will be considered late filers. They may be assessed $50 a day, per plan, for the period for which they failed to file.
- *Nonfilers*—Plan administrators who fail to file required reports and are subsequently identified by the PWBA will be considered nonfilers. They may be assessed a penalty of $300 per day, per plan, with the penalty continuing to accrue up to $30,000 per year for each plan year until a filing is submitted.

.12 *Form 5500 Reporting Requirements.* The instructions to the 1992 Form 5500 indicated that use of the Schedule G, Financial Schedules, by plans answering "yes" to Items 27a through 27f on the 1993 Form 5500, would be optional for the 1992 plan year and mandatory for the 1993 plan year. Because a number of service providers may be unable to modify their computerized recordkeeping systems in time to provide plan administrators with the required information in the format prescribed by Schedule G for the 1993 plan year filings, mandatory use of Schedule G has been deferred. The PWBA has indicated that it will not reject Form 5500 Annual Return/Report filings for the 1993 plan year solely because of a failure to file required financial schedules in accordance with the format prescribed by Schedule G. However, plan auditors and administrators should be aware that while the use of the Schedule G *form* is optional, the *information* required by that schedule still must be included in the filings.

.13 *Extension of Enforcement Policy.* The PWBA's Technical Release 92-1 provides interim relief from the trust and certain annual reporting requirements, including the audit requirements, of ERISA for so-called cafeteria plans (described in section 125 of the Internal Revenue Code). Interim relief was originally to expire on December 31, 1993. However, the PWBA has determined that relief should remain in effect until the adoption of final regulations addressing the trust and reporting requirements of Title I of ERISA for welfare plans that receive participant contributions. Plan auditors should be alert for the issuance of such regulations.

.14 *Reporting Participant Loans.* The DOL requires that loans to participants of plans that offer such a feature (for example, 401(k) or annuity plans) be included as investments on Form 5500 and disclosed in the Schedule of Assets Held for Investment Purposes. Loans that meet the requirements of the DOL's regulations under ERISA section 408(b)(1) may be aggregated and presented with a general description of terms and interest rates. The DOL may reject filings that do not properly disclose participant loans on the Schedule of Assets Held for Investment Purposes.

.15 *Contributions of Property.* The Supreme Court recently ruled *(Commissioner v. Keystone Consolidated Industries Inc.)* that the contribution of property to a defined benefit pension plan by the plan's sponsoring employer is a prohibited transaction under section 4975(c)(1)(A) of ERISA.

.16 In light of this ruling, the Internal Revenue Service is looking at plans with significant amounts of employer assets for possible prohibited transactions and examining whether plan assets are being appropriately valued. Paragraphs 11.09 through 11.16 of the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* (the Guide) provide auditors with guidance regarding the course of action that they should take when, as part of an audit, they become aware that prohibited transactions, such as contributions of property by plan sponsors, may have occurred. Auditors should also be alert for any guidance issued by the DOL in this area.

Legislative Developments

.17 *Pension Reform.* Recently, attention has been focused on underfunded retirement plans and how the PBGC's growing accumulated deficit will affect its ability to meet its obligation to guarantee employees' benefits under most private sector defined benefit pension plans. H.R. 3396, The Retirement Protection Act of 1993, was introduced in Congress in October 1993 in response to these concerns. The bill is intended to increase the security of the pension system and improve the PBGC's ability to meet its obligations to plan participants. It would modify existing rules to encourage employers to more fully fund their defined benefit pension plans and would amend various qualification requirements, including minimizing the ability of sponsors of underfunded plans to select interest and mortality assumptions for purposes of calculating their minimum contributions, imposing substantial limitations on the ability to cross-test defined contribution plans (for example, age-weighted profit-sharing plans) and modifying the interest and mortality assumptions used for calculating lump sum distributions from defined benefit plans. Auditors should be aware that such changes could, among other things, affect a plan's tax qualification status, which may have a direct and material effect on the plan's financial statements, as described in SAS No. 54, *Illegal Acts by Clients* (AU section 317), and should be alert for any new developments in this area.

.18 *ERISA Audit Improvement Act.* Congress is being asked to consider the ERISA Audit Improvement Act, the objective of which is, among other things, to improve ERISA provisions with respect to the audits of the financial statements of employee benefit plans.

.19 If enacted, the Act would repeal the limited scope audit exemption and mandate external quality control reviews every three years for public accountants who conduct ERISA audits. The Act would also require qualified public accountants to report directly to the Secretary of Labor certain events that come to their attention during the audit.

.20 Auditors should be aware that this Act could substantially change the way benefit plan audits are conducted and could significantly affect their audit practice. Auditors should be alert to any new developments in this area.

Audit and Accounting Developments

Audit Issues

.21 *Derivatives and Other High-Risk Investments.* In response to low interest rates and in an attempt to earn higher yields, a number of investment managers have revised their investment strategies. Generally, the changes involve the purchase of more complex financial instruments that can involve a substantial risk of loss. Investors in such instruments should have the expertise necessary to understand and manage the related risks. As discussed below, auditors should also be familiar with such instruments and the associated risks. One class of these instruments—derivatives—requires particular attention.

.22 Derivatives are complex financial instruments whose values depend on the values of one or more underlying assets or financial indexes. Derivatives generally fall into at least two categories, as follows:

- Asset-backed securities that include mortgage-backed securities, interest-only and principal-only strips, and tranches of collateralized mortgage obligations
- Off-balance-sheet instruments such as forward contracts, interest-rate and currency swaps, futures, options, and other financial contracts

By reconfiguring cash flows associated with underlying assets, an issuer can create asset-backed securities that meet the needs of and are attractive to various potential users or investors by isolating, enhancing, or diluting one or more of credit, liquidity, interest-rate, and other risks inherent in the underlying cash flows. For example, through mortgage-backed securities, the issuer can enhance the marketability of underlying mortgage loans by spreading liquidity and credit risk across broad pools, or by providing a higher yield to those users willing to accept a higher concentration of the risks associated with specific collateral cash flows. Similarly, users find certain derivatives attractive because they can purchase the risks and rewards they desire most, or can synthetically create a security with the desired risk and reward characteristics.

.23 Accounting for derivatives is complex. Given the constant innovation and complexity of derivatives, accounting literature does not explicitly cover some derivatives, however, several related projects are under way.

.24 The innovative and complex nature of such investment vehicles may significantly increase audit risk. For example, as more and more financial institutions enter the markets for such instruments, their profitability may diminish. Traders may attempt to compensate for the diminution by increasing the volume of transactions involving such instruments or by further customizing products. An increase in volume may be accompanied by trading with counterparties that have higher credit risk. Customizing transactions may increase valuation difficulties. The propriety of the methods used to account for transactions involving sophisticated financial instruments and to determine their value should be carefully considered. Understanding the substance of transactions in such instruments is important in determining the propriety of their accounting treatment. In some circumstances, auditors may find it helpful to consult with experts. SAS No. 22, *Planning and Supervision* (AU section 311) requires that an auditor understand the events, transactions, and practices that, in the auditor's judgment, may have a significant effect on the financial statements. Accordingly, auditors of the financial statements of users and issuers of derivatives should be aware of the various risks involved with derivatives and in planning the audit should consider—

- The nature and extent of the use of derivatives.
- The level of expertise of the plan's investment managers in monitoring, evaluating, and accounting for derivatives.
- The policies and procedures established for investment in high-risk derivatives and the degree of oversight by the plan administrator.
- The involvement of specialists in valuing derivatives.

The auditor should consider the work of any specialist used in valuing derivatives when auditing complex derivatives. See guidance in SAS No. 11, *Using the Work of a Specialist* (AU section 336).

.25 *Reporting on Supplemental Schedules.* The Guide includes guidance on reporting on supplemental schedules that are required by the DOL's Rules and Regulations for Reporting and Disclosure under ERISA. The report on supplemental information that is prescribed in the Guide for use when a full scope audit has been performed differs from that to be used when a limited scope audit has been performed. Some auditors are confused about the differences in these reports. According to the Guide, when an audit in accordance with generally accepted auditing standards (in other words, a full scope audit) has been performed, the auditor's report on the supplemental schedules need not state that the schedules comply with the DOL filing requirements. However, when a limited scope audit has been performed, the Guide states that the auditor's report includes the auditor's opinion as to whether the *form and content* of the information included in the financial statements and DOL schedules is presented in compliance with the DOL's rules and regulations under ERISA. In either case, when the auditor concludes that the supplemental schedules do not contain all required information or contain information that is inaccurate or is inconsistent with the financial statements, the auditor should consider either adding an explanatory paragraph to the report on the schedules or expressing a qualified or adverse opinion on the supplemental schedules. The Guide contains a table that illustrates the report modifications that an auditor might consider to be necessary when a schedule, or information thereon, is omitted or when information included in a schedule is materially inconsistent with the financial statements.

.26 *Limited Scope Audit Exemption.* ERISA section 103(a)(3)(C) allows auditors to limit the scope of their testing of investment information prepared and certified by a qualified trustee or custodian. A number of auditors, however, have assumed that the exclusion applies to investment information other than that certified by a qualified trustee or custodian or to other noninvestment information (for example, benefit payments, employer/ employee contributions, and receivables). Auditors should be aware that the scope limitation and the corresponding limitation of the auditor's work extends *only* to investments and related investment activity certified by the qualified trustee or custodian. Plan investments not held by a qualified trustee or custodian, and *all* noninvestment related information should be subjected to the same audit procedures as for a full scope audit. The auditor's responsibilities in limited scope engagements are discussed in detail in paragraphs 7.45 and 7.46 of the Guide.

.27 *Review of Form 5500.* Plans that meet certain criteria are required to file audited financial statements along with Form 5500. When audited financial statements are filed along with a plan's Form 5500, the auditor should read the Form 5500 and consider whether it is materially inconsistent with the financial statements that are to be included in the filing. See paragraph 12.12 of the Guide.

.28 Auditors may encounter situations in which the financial statements and auditor's report are issued for purposes other than ERISA filings prior to the completion of the Form 5500. In such situations, the auditor should inform the plan administrator that the financial statements and auditor's report are not to be attached to the Form 5500 filing without the auditor's review of the filing on Form 5500. See paragraphs 12.15 and 12.16 of the Guide for guidance on the auditor's responsibility when reports are issued prior to the Form 5500 filing.

.29 *Reporting on Fund Information.* Requirements for presenting information related to separate investment fund options of defined contribution plans are described in paragraph 3.23(k) of the Guide. When the required information on separate investment options is presented on the face of the financial statements, the auditor's measure of materiality remains that with respect to the financial statements taken as whole, rather than each investment fund option. Paragraph 13.36 of the Guide contains an auditor's report on the financial statements of a savings plan containing separate investment fund option information, filed with Form 5500, which illustrates the appropriate reporting in such a situation.

Audit Development

.30 *SAS on Service Organizations.* In April 1992 the AICPA Auditing Standards Board issued SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AU section 324), which is effective for service auditors' reports dated after March 31, 1993. SAS No. 70 (AU section 324) supersedes SAS No. 44, *Special-Purpose Reports on Internal Accounting Control at Service Organizations.* SAS No. 70 (AU section 324) provides guidance to auditors of financial statements of entities that use service organizations, such as bank trust departments, that provide investment or administrative services to employee benefit plans.

.31 When an organization uses a service organization, transactions that affect the user organization's financial statements are subjected to policies and procedures that may be physically and operationally separate from the user organization. Consequently, the internal control structure of a user organization may include a component that is not directly under the control and monitoring of the user organizations management. For this reason, planning the audit may require that a user auditor gain an understanding of policies and procedures at the service organization that may affect the user organization's financial statements. If control policies and procedures at a service organization have a significant effect on assertions in a user organization's financial statements, the user organization's auditor may find a service auditor's report helpful in gaining an understanding of an entity's internal control structure and in assessing control risk.

.32 Many bank trustees are on a calendar year and, consequently, obtained special-purpose reports in accordance with SAS No. 44 prior to March 31, 1993, for use by auditors in audits of 1992 plan financial statements. Auditors should be aware that such reports are not acceptable for use by auditors in audits of 1993 plan financial statements. Trustees should engage auditors to prepare service auditors' reports that are prepared in accordance with SAS No. 70 (AU section 324) for use by plan auditors in audits of 1993 plan financial statements.

.33 Auditors should also be aware that although a service auditor's report on policies and procedures placed in operation at the service organization may be helpful in providing a sufficient understanding to plan the audit, the auditor should not rely on such a report to justify a reduction of the assessed level of control risk below the maximum. If the auditor plans to use a service auditor's report to reduce the assessed level of control risk, he or she should obtain a service auditor's report on policies and procedures placed in operation that includes tests of operating effectiveness.

.34 The AICPA is also preparing an auditing procedure study that provides assistance to user auditors as well as service auditors in the implementation of SAS No. 70 (AU section 324).

Accounting Issue

.35 Paragraph 3.23(m) of the Guide requires that the plan disclose the amounts of assets that have been allocated to participants who have withdrawn from the plan as of year end, but for which disbursement of those funds from the plan has not yet been made. The amount should be disclosed in the notes to the financial statements. It should not be classified as a liability in the statement of net assets available for benefits. When evaluating the adequacy of disclosures in this area, auditors should be aware that for plans filing under the alternative method, the DOL requires that these amounts be reported as liabilities on Form 5500, which will require a reconciling note in the plan's financial statements as described in paragraphs A.41 and A.42(c) of the Guide.

Accounting Developments

.36 *Valuation of Insurance and Investment Contracts.* The FASB has issued FASB Statement No. 110, *Reporting by Defined Benefit Pension Plans of Investment Contracts* (AC Pe5), which is an amendment to FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans* (AC Pe5). FASB Statement No. 110 (AC Pe5) requires fair-value reporting for all investment contracts held by defined benefit pension plans. However, it permits the continued use of contract value for insurance contracts as defined in FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises* (AC In6), as well as deposit administration and immediate participation guarantee contracts entered into before March 20, 1992. FASB Statement No. 110 (AC Pe5) is effective for fiscal years beginning after December 15, 1992.

.37 In September 1993, the AICPA's Employee Benefit Plans Committee issued an exposure draft proposed statement of position (SOP), *Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined Contribution Pension Plans,* that, in final form, will provide guidance on how those plans should report investment contracts issued by insurance companies, banks, thrift institutions, and others. In addition, the proposed SOP would provide guidance for determining the fair value of investment contracts held by all types of plans. The proposed SOP may substantially change the way certain investment contracts are reported. Auditors should be alert for final guidance in this area.

.38 *Reporting Investment Contracts Issued by Troubled Insurance Companies.* The Guide currently permits the reporting of investment contracts issued by insurance companies that are held by health and welfare plans and defined contribution pension plans at the value, determined on Schedule A, Insurance Information, of Form 5500, that is contract value. In the current economic environment, certain of these contracts may have been issued by what are now troubled insurance companies. In these cases, the auditor should be aware that continuing to carry the assets at contract value may not be appropriate, because the plan may not recover the entire contractual amount. When addressing problem contracts, auditors should consider the guidance in FASB Statement No. 5, *Accounting for Contingencies* (AC C59).

.39 *Fair Value Disclosures.* FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* (AC F25), requires all entities to disclose, within the body of the financial statements or in the accompanying notes, the fair value of financial instruments, both assets and liabilities recognized and not recognized in the statement of financial position, for which it is practicable to estimate fair value. Generally, financial instruments of an employee benefit plan other than insurance contracts as defined in FASB Statement No. 110 (AC Pe5), are included in the scope of FASB Statement No. 107 (AC F25) and are subject to the disclosure requirements of paragraphs 10–14 (AC F25.115C-.115G) of the Statement.

.40 An entity also should disclose the method(s) and significant assumptions used to estimate the fair value of financial instruments. Since these disclosures are made by defined benefit pension plans in accordance with FASB Statement No. 35 (AC Pe5), as amended, and by defined contribution plans in accordance with the provisions of the Guide, the disclosure requirements of FASB Statement No. 107 (AC F25) typically will be met by complying with FASB Statement No. 35 (AC Pe5), as amended, or the Guide, as appropriate.

.41 *Health and Welfare Benefit Plans.* In August 1992, the AICPA Employee Benefit Plans Committee issued SOP 92-6, *Accounting and Reporting by Health and Welfare Benefit Plans.* The SOP clarifies several accounting and reporting requirements set forth in chapter 4 of the Guide and updates the Guide to incorporate new statements issued by the FASB. Significant changes include clarification of—

- The objective of financial reporting by defined benefit health and welfare plans.
- How defined benefit health and welfare plans, both single-employer and multiemployer, should account for and report benefit obligations, including postretirement obligations.
- The requirement to recognize claims incurred but not reported.
- The stipulation that benefit obligations should not include death benefits actuarially expected to be paid during participants' period of active service.
- The distinction between defined contribution health and welfare plans and defined benefit health and welfare plans.
- The requirement that the current insurance premium rates used in determining the obligation for accumulated eligibility credits should generally consider mortality rates and the probability of employee turnover.

SOP 92-6 is effective for audits of single-employer plans with more than five hundred participants for plan years beginning after December 15, 1992; for audits of single-employer plans with no more than five hundred participants for plan years beginning after December 15, 1994; and for audits of multiemployer plans for plan years beginning after December 15, 1995. When a plan adopts the SOP, the plan must adopt it in its entirety. Accounting changes adopted to conform to the provisions of the SOP shall be made retroactively. Because ERISA requires comparative statements of net assets available for plan benefits, it will be necessary to restate the prior year's statement of net assets in the year of adoption in an ERISA audit to comply with the provisions of the SOP. In addition, because accumulated benefit obligations are not reported on Form 5500, plans adopting SOP 92-6 for the 1993 plan year should include a note to their financial statements reconciling the amounts reported in the financial statements to amounts reported on Form 5500, as described in paragraphs A.41 and A.42(c) of the Guide.

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.42 This audit risk alert supersedes *Employee Benefit Plans Industry Developments—1993.*

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.43 Auditors should also be aware of the economic, regulatory, and professional developments that may affect the audits they perform as described in *Audit Risk Alert—1993* [AAM section 8010].

[The next page is 8179.]

AAM Section 8070
State and Local Governmental Developments—1994

Industry and Economic Developments

.01 Although the economy in general has improved during the last year, the pace of recovery has been slow. Recent governmental studies indicate that many state and local governments continue to be challenged in responding to varied revenue and spending pressures. Service demands on state and local governments continue to increase without a corresponding increase in revenues.

.02 On the revenue side, property tax revenues are likely to take some time to recover from declines in the tax bases. Stubborn unemployment rates continue to affect income tax revenues. Many state and local governments also have legal limitations placed on taxing levels that result in further constraints on the ability to raise revenue. On the spending side, while almost all categories of programs are growing, certain programs are growing more rapidly. Increasing enrollment in primary schools has increased the demand for education spending. Spiraling health care costs have also contributed to the outpacing of expenses over revenues. Unfunded federal and state mandates (for example, administering environmental laws enacted by Congress) have been on the rise, many at considerable cost to state and local governments. Another area of concern is underfunded state and local pension plans. Recent studies indicate that, on average, these plans are approximately 15 percent underfunded, which equates to more than $125 billion in total unfunded pension liabilities.

.03 The low interest rates continue to be both beneficial and detrimental to many governments. The lower rates have allowed many governments to refinance existing debt at lower rates. At the same time, however, the lower rates have reduced the return on investments held by governmental entities and have had a significant impact on many retirement systems.

.04 In preparing their budgets, state and local governments face constraints imposed by law and taxpayer concerns. Many governments have some form of balanced budget requirement. The expectation of balance by taxpayers, as well as concern with bond ratings, also motivates state and local officials to try to achieve such balance. To meet requirements of these balanced budgets, governments may use a variety of methods, such as "one-shot" accounting adjustments or using fund balances accumulated in past years, to reduce or eliminate shortfalls of revenues over expenditures. One-shot adjustments, similar to those used by some governments in the past, may be used by still others this year. Such adjustments have included—

- Early retirement programs for employees or delays in pension contributions to reduce cash-based budgets.
- Delaying payment of salaries or benefits to reduce expenditures in budgetary or cash-basis financial statements.
- Backloading of employee benefits to future periods when negotiating new contracts for union employees.
- Delaying payments to internal service funds for insurance and other services.
- Making transfers to the general fund from other funds to decrease the general fund deficits without improving the financial condition of the government.
- Debt restructuring or refinancing to extend the payment period.
- Selling assets or deferring maintenance of buildings or infrastructure, both of which can give the appearance of improving a government's current financial position.

- Special one-time increases in nontax fees.

If such measures are taken, auditors should be alert to possible violations of legal or contractual requirements and should consider whether adequate disclosure has been made in the financial statements.

Specific Industry Conditions or Risk Factors

.05 *Political Environment of Government Accountability.* Because governmental entities operate in a politically sensitive environment, the potential for publicized claims of mismanagement, defalcation, or noncompliance with laws and regulations is much greater than in other environments. Many governments have passed legislation on financial accountability and internal controls because of the increased public focus on the fiscal accountability of elected officials and government employees. Such laws and regulations often include—

- Financial management conduct and integrity, which cover topics such as internal controls, conflicts of interest, and general government ethics.
- Restrictions, particularly where federal funding is in place, on political activities and lobbying.
- Restrictions on out-of-state travel and use of publicly owned property for personal travel.
- Restrictions on acceptance of gifts, meals, and entertainment.
- Additional guidelines on investment practices and cash management, including banking relationships.
- Policies governing the recovery of indirect costs.
- Balanced-budget proposals, including restrictions on amendments to budgets.
- Requirement for additional documentation of the bidding process related to the purchase of goods or services.
- Restrictions on political contributions from investment bankers and others.
- Restrictions on negotiated bond sales.
- Potential new regulations, disclosures, and filing requirements for municipal security offerings.

.06 AICPA Statement on Auditing Standards (SAS) No. 54, *Illegal Acts by Clients* (AU section 317), requires an auditor to consider laws and regulations that, if noncompliance occurs, could have a direct and material effect on the financial statement amounts. *Government Auditing Standards,* issued by the Comptroller General of the United States and often referred to as the Yellow Book, also requires auditors to test and report on compliance with laws and regulations. Therefore, auditors should be alert for possible violations of such laws and regulations.

.07 *Going Concern.* It is generally believed that governmental entities will continue as going concerns because of their ability to raise revenues to meet obligations. Although this continues to be true for most general governments, taxpayer initiatives and limitations due to the lack of taxpayer resources have placed limits on many governments' taxing power. In addition, many special-purpose governments do not have the power to raise fees or taxes without the support of some other governmental body.

.08 SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU section 341), requires that, as part of every audit, the auditor evaluate whether the results of audit procedures performed identify conditions and events that, when considered in the aggregate, indicate that there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of financial statements being audited. During this evaluation, the auditor should consider factors such as the likelihood of default on debt (for example, revenues less than originally forecasted for repayment of revenue bonds), use of deficit financing bonds, large unfunded pension obligation combined with diminishing revenues, declining tax base (for example, declining population, school enrollment, per capita personal income, number and value of building permits or business licenses, or retail sales), increasing reliance on external funding, and the ability of one fund to continue to support the activities or operations of another fund incurring large deficits (for example, the general fund's ability to continue to support a transit system, or the lottery's ability to continue to provide support to the general governmental operations).

.09 If, after considering the identified conditions and events in the aggregate, the auditor believes there is substantial doubt about the ability of the entity to continue as a going concern for a reasonable period of time, the auditor should consider management's plans for dealing with the adverse effects of the conditions and events. The auditor should obtain information about the plans and consider whether it is likely that the adverse effects will be mitigated for a reasonable period of time and that such plans can be effectively implemented. When evaluating management's plans, the auditor should identify those elements that are particularly significant to overcoming the adverse effects of the conditions and events and should plan and perform auditing procedures to obtain evidential matter about them.

Industry Conference

.10 The AICPA will hold its eleventh annual National Governmental Accounting and Auditing Update Conference on August 15 and 16, 1994, in Washington, DC and again on September 22 and 23, 1994, in Phoenix, Arizona. This conference will benefit public practitioners; officials working in federal, state, or local governmental finance and accounting; and recipients of federal financial assistance. Participants will receive updates on current issues, practical advice, and timely guidance on recent developments from experts. For more information about the conference, please call the AICPA Meetings and Travel Department at (201) 938–3232.

Regulatory and Other Developments

Revisions to Government Auditing Standards

.11 The U.S. General Accounting Office (GAO) is expected to issue a revised *Government Auditing Standards* in June 1994. The standards for financial audits will be effective for periods ending on or after January 1, 1995. Significant changes are expected to the proposed standards that the GAO exposed for comment in July 1993. In particular, the final standards will offer *guidance* on internal controls in place of the expanded testing *requirements* that had been proposed. The revised standards are expected to—

- Add a requirement for both governmental and nongovernmental audit organizations to submit a copy of their most recent external quality control review report to the party contracting for an audit.
- Add a requirement to design the audit to detect noncompliance with contract provisions and grant agreements that could have a direct and material effect on financial statement amounts.
- Add a requirement that working papers identify client documents and transactions that the auditor examined.
- Add a requirement for the auditor to communicate to audit committees or other responsible parties the auditor's responsibilities for consideration of internal controls and compliance with laws and regulations.
- Add a requirement to include a reference to *Government Auditing Standards* in audit reports when they are being submitted in accordance with a law or regulation calling for an audit in accordance with *Government Auditing Standards.*
- Add a requirement that the report on the financial statements either (1) describe the results of the auditor's tests of internal controls and compliance or (2) refer to separate reports on controls and compliance.
- Add a requirement that the auditor report irregularities and illegal acts directly to parties outside the client, even if they have resigned or been dismissed from the audit.

- Delete the requirement to describe categories of internal controls in the report on internal controls.
- Delete the requirement to express positive and negative assurance on compliance with laws and regulations.
- Incorporate relevant AICPA SASs (for example, SAS No. 62, *Special Reports* (AU section 623)) and attestation standards into *Government Auditing Standards* for financial related audits.

Auditors should be alert for the issuance of these revised standards.

Revisions to the Office of Management and Budget's Compliance Supplement for Single Audits of State and Local Governments

.12 The Office of Management and Budget (OMB) is expected to issue revisions to its *Compliance Supplement for Single Audits of State and Local Governments.* This publication sets forth the compliance requirements that are to be considered in single audits of state and local governments. The revisions are intended to update the specific program requirements to incorporate new laws and regulations and to make changes to the General Requirements, which will now be called Common Requirements. It is expected that these revisions will be issued in August 1994. These revisions will be effective upon their issuance.

Update on OMB Circulars

.13 *OMB Circular A-21.* In July 1993, the OMB published final revisions to OMB Circular A-21, *Cost Principles for Educational Institutions.* The revisions are effective for fiscal years beginning on or after January 1, 1994. Earlier implementation is encouraged. The revision clarifies and standardizes the principles for determining costs applicable to grants, contracts, and other agreements with educational institutions. In addition, by mid-1994, the OMB is expected to further revise this circular to incorporate four standards promulgated by the Cost Accounting Standards Board (Cost Accounting Standards 501, 502, 505, and 506) and a Cost Accounting Standards Board Accounting Policies Disclosure Statement. Once the four cost accounting standards are incorporated into OMB Circular A-21, they will be applicable to both contracts and grants.

.14 *OMB Circular A-87.* The OMB proposed revisions to OMB Circular A-87, *Cost Principles Applicable to State and Local Governments,* in August 1993. A final revised circular is expected to be issued in July 1994 and to be effective for grantee fiscal years beginning after the issuance of the circular. The proposal conforms many of the Circular A-87 requirements to those found in Circular A-21. Specifically, the proposed revisions would—

- Restrict audit costs charged to federal programs to the percentage that federal funds expended represent of total funds expended by the recipient or subrecipient during the fiscal year.
- Allow interest on equipment and building improvements.
- Clarify allowability of depreciation and use charges.
- Disallow self-assessed sales and other general-purpose taxes.
- Clarify lobbying, litigation, and mass severance pay cost prohibitions.
- Allow costs based on generally accepted accounting principles if they are funded for pension costs, retiree health benefits, employee leave, and insurance reserves.

.15 *OMB Circular A-110.* In November 1993, the OMB published final revisions to OMB Circular A-110, *Uniform Administrative Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals, and Other Nonprofit Organizations.* The circular applies to all federal agencies and includes adoption of the audit requirements of OMB Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit*

Institutions. Provisions that affect grantees will be adopted by agencies in codified regulations by May 30, 1994. Earlier implementation is encouraged by the OMB.

Cognizant Agency Assignments

.16 OMB Circular A-128, *Audits of State and Local Governments,* establishes the concept of cognizant agency audit organizations (cognizant agencies) and defines the term as the federal agency assigned by the OMB to carry out the responsibilities concerning single audits of governments as defined in the circular. When professional judgment indicates it is appropriate, auditors may communicate with cognizant agencies before, during, and after the audit to avoid or minimize disagreements or other problems.

.17 As the result of changes in federal government funding patterns, the OMB is revising its list of designated cognizant agencies for state and large local governmental units. The OMB anticipates completing these revisions during the next year.

.18 Additional audit planning considerations relative to auditors' relationships with and the responsibilities of cognizant agencies are discussed in chapter 2 of the AICPA's Statement of Position (SOP) 92-7, *Audits of State and Local Governmental Entities Receiving Federal Financial Assistance.*

Future Single Audit Developments

.19 Several organizations have recently completed or are near completion of studies on the single audit process. The President's Council on Integrity and Efficiency (PCIE) Standards Subcommittee issued a report, *Study on Improving the Single Audit Process,* in September 1993. The report contains seventy-seven specific recommendations that include proposed changes to the Single Audit Act and OMB Circular A-128. Among the specific recommendations, the report advocates raising the threshold for required single audit coverage, increasing internal control testing requirements, and moving to a risk-based audit approach.

.20 The GAO is also nearing completion of its own study on the single audit process. It is expected that this study will result in ten specific recommendations, many of which are similar to the results of the PCIE study. Some of the GAO's expected recommendations would require amendments to the Single Audit Act; however, as of the date of this audit risk alert, it is still uncertain whether Congress will consider amendments to the statute in 1994.

.21 Based on the results of these studies and other factors, the OMB is moving forward on a project to revise OMB Circulars A-128 and A-133. It is expected that this project not only will revise these circulars to include certain of the PCIE and GAO recommendations, but will also combine the circulars into one circular that will apply to state and local governments, colleges, universities, and nonprofit organizations. Combining the circulars would also result in future OMB projects to combine the *Compliance Supplement for Single Audits of State and Local Governments* and the *Compliance Supplement for Audits of Institutions of Higher Learning and Other Non-Profit Organizations.*

Arbitrage Rebate

.22 In June 1993, the U.S. Department of the Treasury released revised final regulations regarding the calculation of arbitrage rebate, as well as other aspects of arbitrage law under section 148 of the Internal Revenue Code (the 1993 regulations). These regulations are generally applicable to tax-exempt bonds issued after June 30, 1993. Previous final regulations issued in May 1992 (the 1992 regulations) govern rebate calculations for such bonds issued prior to July 1, 1993.

.23 The 1993 regulations are significantly shorter than the 1992 regulations, yet they address more topics. They accomplish this by eliminating many detailed rules and replacing them with general rules. The 1993 regulations are intended to clarify and simplify certain arbitrage compliance matters. However, even with such simplification, this area remains very complex. The arbitrage rebate rules continue to be an area of concern for all entities that issue tax-exempt debt. Therefore, increased audit scrutiny may be warranted on arbitrage rebate liability computations and on how any resulting liability is reported in the financial statements.

Audit Issues and Developments

Revised AICPA Audit and Accounting Guide Audits of State and Local Governmental Units

.24 The Government Accounting and Auditing Committee of the AICPA expects to issue a final revised Audit and Accounting Guide, *Audits of State and Local Governmental Units,* in mid-1994. The auditing guidance in the revised Guide will be effective for audits of financial statements for periods ending after September 15, 1994, *with earlier implementation encouraged.* The effective dates of Governmental Accounting Standards Board (GASB) accounting and reporting guidance included in the revised Guide should be applied as provided for in the related literature. The objectives of the revised Guide are to provide (1) a general background of the governmental environment and (2) practical guidance to practitioners on accounting, auditing, and financial reporting for state and local governmental units.

.25 The revised Guide incorporates new accounting and financial reporting requirements resulting from Statements issued by the GASB, as well as other accounting guidance, some of which was in earlier editions of the Guide but not addressed in GASB pronouncements.

.26 The revised Guide provides accounting guidance for interfund borrowings, the recording of debt proceeds, transfers of fixed assets, and unearned developers' deposits. It also presents alternative accounting treatments for tap fees, no-commitment debt, and lotteries.

.27 Also incorporated in the revised Guide are requirements established by auditing standards issued by the AICPA since the publication of the 1986 version of the Guide, the 1988 revision of *Government Auditing Standards,* and OMB Circular A-133. SOP 92-7 is superseded by the revised Guide. The information from SOP 92-7, however, has been incorporated.

.28 The revised Guide also includes final guidance from the related February 1993 exposure draft of an SOP entitled *Reporting on Separately Issued Summary Financial Information Prepared by State or Local Governmental Units.* For this reason, a final SOP on this topic will not be issued.

.29 Finally, certain sections of SAS No. 68, *Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance* (AU section 801), have been incorporated into the revised Guide because of proposed revisions to SAS No. 68 (see the following section for further information on the proposed revisions).

Proposed Revision to SAS No. 68

.30 In 1993 the AICPA Auditing Standards Board (ASB) formed a task force to consider revisions to SAS No. 68 (AU section 801) as a result of guidance issued in the form of SOPs in 1992 and the potential for future revisions resulting from changes in *Government Auditing Standards* and in regulations governing compliance audits, such as the single audit and compliance audits of not-for-profit organizations. The ASB task force was also asked to consider what action could be taken to avoid the need to revise SAS No. 68 (AU section 801) each time the federal regulations—whether issued by the GAO, the OMB, or Congress—change.

.31 The task force recommended, and the ASB agreed, that SAS No. 68 (AU section 801) could become a "skeleton" SAS on the subject of compliance auditing. The skeleton SAS will contain overall guidance, but not the detailed reporting and testing guidance currently in SAS No. 68 (AU section 801). Information being deleted from

SAS No. 68 (AU section 801) is either currently in an SOP or will be in the revision of the Audit and Accounting Guide *Audits of State and Local Governmental Units* now being finalized.

.32 The exposure draft of the proposed SAS was issued in May 1994 and a final SAS is expected to be issued in the fourth quarter of 1994.

Access to Working Papers

.33 An increasing number of governmental agencies (*regulators*) are requesting that auditors provide them with access to audit working papers. These requests generally are made pursuant to a law, a regulation, or the audit contract. As part of the regulator's review of the working papers, the regulator may request photocopies of all or selected portions of the working papers during or after the review. In addition, the regulator may intend, or decide, to make photocopies (or information derived from the original working papers) available to others, including other governmental agencies, for their particular purposes, with or without the knowledge of the auditor or client. To provide auditors in these situations with guidance on responding to and fulfilling such requests, the Audit Issues Task Force of the ASB issued an Interpretation of SAS No. 41, *Working Papers*, entitled "Providing Access to or Photocopies of Working Papers to a Regulator" (AU section 9339). The complete text of this Interpretation will be published in the July 1994 issue of the *Journal of Accountancy* ("Official Releases").

Letters for Underwriters

.34 Underwriting agreements between the governmental issuer of debt and the underwriters may require the auditor to prepare a comfort letter addressed to the underwriter. The ASB issued SAS No. 72, *Letters for Underwriters and Certain Other Requesting Parties* (AU section 634), which became effective for all comfort letters issued on or after June 30, 1993. This guidance supersedes SAS No. 49, *Letters for Underwriters*. SAS No. 72 (AU section 634) defines the term *underwriters* and gives guidance to accountants on providing letters to underwriters and certain other requesting parties. Auditors should refer to the general *Audit Risk Alert—1993* for further guidance in this area.

Environmental Liability Issues

.35 State and local governmental entities are subject to a number of financial risks as a result of environmental hazards or issues. Risks may arise, for example, from a governmental entity's operations, from properties owned or operated by a governmental entity (such as schools built with asbestos or landfills identified as Superfund sites), or from facilities acquired by a governmental entity based on tax liens (such as an old filling station with leaking underground storage tanks). National Council on Governmental Accounting Statement 4, *Accounting and Financial Reporting Principles for Claims and Judgments and Compensated Absences*, requires governments to apply the provisions of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (AC C59). This Statement requires governmental entities to report liabilities, such as environmental liabilities, when they are probable and reasonably estimable. FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss* (AC C59), requires that if a range of estimates is available and some amount within the range appears to be the better estimate, that amount should be used. If no amount within the range is a better estimate than any other amount, however, the minimum amount in the range should be accrued. Disclosure of contingent liabilities is required if the amount of a loss cannot be estimated or if a loss, although estimable, is only reasonably possible. Auditors should inquire of management and, as appropriate, legal counsel about the status of any actions or litigation related to environmental issues.

Program-Specific Audits

.36 OMB Circulars A-128 and A-133 permit recipients of $25,000 to $99,999 of federal financial assistance annually to have audits of individual federal programs rather than an organization-wide or "single audit" of all federal financial assistance received. OMB Circular A-133 extends the same option to nonprofit organizations that receive federal financial assistance under only one program, regardless of the dollar amount.

.37 To date there has been very little guidance issued on performing and reporting on program-specific audits. The PCIE issued PCIE Position Statement 6, *Questions and Answers on OMB Circular A-133,* which provides clarifications and practical working guidance on, among other things, program-specific audits. Auditors may want to consider the guidance in this document when engaged to perform a program-specific audit.

.38 Auditors reporting on program-specific audits should be in accordance with the requirements of the relevant program-specific audit guide issued by a federal department. Where no such audit guide is available, reporting should be in accordance with *Government Auditing Standards.* Reports will normally be issued on the financial statements of the program, on internal controls, and on compliance.

.39 Compliance requirements for testing should be determined from the program-specific audit guide. Where no such audit guide is available, the auditor may wish to consider any program requirements contained in the OMB's Compliance Supplement to Circular A-128 or A-133, as well as the grant agreement.

.40 In July 1993, the PCIE issued a *Revised Program Audit Guide Listing* that supersedes the October 1991 *Program Audit Guide Survey.* This listing is intended to assist practitioners in obtaining the most current guidance concerning federal program-specific audits. The guides listed in the document may also be helpful in understanding individual programs and performing audits under OMB Circular A-128 or A-133.

Budgetary Practices

.41 In government, unlike the private sector, the budget, not the annual report, is often considered to be the most significant fiscal document. The budget is the expression of public policy and intent. It is the focal point of public interest and can be of significant interest to the rating agencies. When conducting an audit of a state or local governmental unit, the auditor's understanding of the budget and the budgetary process is important for several reasons. First, the *Codification of Governmental Accounting and Financial Reporting Standards,* section 2400, states that "budgetary comparisons should be included in the appropriate financial statements and schedules for governmental funds for which an annual budget has been adopted." Thus, the auditor needs to understand the budget and the budget process in order to evaluate the appropriateness of budget information in the financial statements. Second, failure to adopt a budget when adoption of a budget is legally required is an illegal act. SAS No. 54, *Illegal Acts by Clients* (AU section 317), states that if the auditor concludes that an illegal act has a material effect on the financial statements, and the act has not been properly accounted for or disclosed, the auditor should express a qualified opinion or an adverse opinion on the financial statements taken as a whole, depending on the materiality of the effect on the financial statements.

.42 Recently there have been concerns that many state and local governments are balancing their budgets with practices that, although legally acceptable, are both misleading and fiscally imprudent. By permitting costs rightfully payable by taxpayers of today to be passed on to taxpayers of the future, these practices diminish public confidence. Even though the auditor's responsibilities for the budget information included in the financial statements are limited to those already described, during the course of the audit the auditor may become aware of budgeting techniques or estimates that clearly may be inappropriate. Although not required by professional standards (unless the techniques or estimates used represent errors, irregularities, or illegal acts), the auditor may want to communicate his or her findings or concerns to appropriate levels of management within the governmental entity.

Accounting Developments

.43 The GASB has issued many new financial accounting or reporting standards applicable to state and local governments. Some of these standards are effective for the first time in 1994. Other standards are not effective until after 1994; however, the GASB encourages early application. The auditor should determine which standards a state or local government is either required to adopt in the current year or has elected to adopt early.

GASB Statements Effective During 1994

.44 *Reporting Entity.* In 1991, the GASB issued GASB Statement No. 14, *The Reporting Entity,* which is effective for financial statements for periods beginning after December 15, 1992. GASB Statement No. 14 establishes standards for defining and reporting on the financial reporting entity and applies to financial reporting by primary governments as well as to separately issued financial statements of governmental component units.

.45 The GASB staff is working on guidance for implementing GASB Statement No. 14 related to specific provisions of the definition of the reporting entity and practical display problems based on questions that have arisen during early implementation. Publication of final guidance is scheduled for June 1994.

.46 *Compensated Absences.* In November 1992, the GASB issued GASB Statement No. 16, *Accounting for Compensated Absences.* The Statement provides guidance for the measurement of accrued compensated absences liabilities by state and local governmental entities, regardless of the reporting model or fund type used to report the transactions. Compensated absences are absences for which employees will be paid, such as vacation, sick leave, and sabbatical leave. GASB Statement No. 16 is effective for financial statements for periods beginning after June 15, 1993. The provisions of GASB Statement No. 16 should be applied in governmental and similar trust funds using a modified accrual basis of accounting. Because the balance sheets of governmental and similar trust funds report current liabilities, only the portion of the liability that normally would be liquidated with expendable available resources should be reported in these funds. The remainder of the liability should be reported in the General Long-Term Debt Account Group.

.47 *Measurement Focus and Basis of Accounting—Amendment to Effective Date of GASB Statement No. 11.* In June 1993, the GASB issued GASB Statement No. 17, *Measurement Focus and Basis of Accounting—Governmental Fund Operating Statements: Amendment of the Effective Dates of GASB Statement No. 11 and Related Statements.* The Statement defers the effective date of GASB Statement No. 11, *Measurement Focus and Basis of Accounting—Governmental Fund Operating Statements,* to periods beginning approximately two years after an implementation standard is issued and modifies the reference in GASB Statement No. 13, *Accounting for Operating Leases with Scheduled Rent Increases,* to the effective date of GASB Statement No. 11. It also establishes an effective date of periods beginning after June 15, 1994, with early application encouraged, for GASB Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues,* for entities other than public entity risk pools, using the modified accrual basis of accounting in governmental and similar trust funds.

.48 *Municipal Solid Waste Landfill Closure and Postclosure Care Costs.* In August 1993, the GASB issued GASB Statement No. 18, *Accounting for Municipal Solid Waste Landfill Closure and Postclosure Care Costs,* which is effective for financial statements for periods beginning after June 15, 1993. This Statement establishes standards of accounting and financial reporting for municipal solid waste landfills (MSWLF) and applies to state and local governmental entities that are required by federal, state, or local laws or regulations to incur MSWLF closure and postclosure care costs, regardless of the reporting model or fund type used to report such costs.

.49 GASB Statement No. 18 defines the components of estimated total current cost of MSWLF closure and postclosure care and generally requires recognition of that cost based on landfill capacity used to date. MSWLFs that use governmental fund and account group accounting and reporting should recognize expenditures and fund liabilities using the modified accrual basis of accounting. The cost components are required to be based on federal, state, or local laws or regulations concerning closure and postclosure care that have been approved as of the balance sheet date, regardless of their effective date. Accordingly, recent Environmental Protection Agency rulemaking that delayed the effective date for municipal solid waste landfill regulations would not affect implementation of the Statement.

.50 State and local governments are required to disclose the nature and source of MSWLF closure and postclosure care estimates, the reported liability at the balance sheet date, the estimated total closure and postclosure care cost remaining to be recognized, the percentage of MSWLF capacity used to date, and the estimated remaining MSWLF life in years. Entities are also required to disclose how closure and postclosure care financial assurance requirements are being met.

.51 *Governmental College and University Omnibus Statement.* In September 1993, the GASB issued GASB Statement No. 19, *Governmental College and University Omnibus Statement,* which requires governmental colleges and universities that follow the model in the AICPA Industry Audit Guide *Audits of Colleges and Universities* to report Pell grants in a restricted current fund. This Statement also requires that if a single fund is used to account for risk financing activities, that fund should be reported as an unrestricted current fund. For Pell grants, GASB Statement No. 19 is effective for periods beginning after June 15, 1993. For risk financing activities, it is effective for periods beginning after June 15, 1994. Earlier application is encouraged.

.52 *Accounting and Financial Reporting for Proprietary Activities.* In September 1993, the GASB issued GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting,* which is effective for financial statements for periods beginning after December 15, 1993, with early application encouraged. GASB Statement No. 20 was issued to clarify the applicability of FASB Statements to accounting and financial reporting for proprietary activities. The Statement provides interim guidance on accounting and financial reporting for proprietary activities pending further GASB research that is expected to lead to the issuance of one or more pronouncements on the accounting and financial reporting model for proprietary activities.

.53 Proprietary activities should apply all applicable GASB pronouncements as well as the following pronouncements issued on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements: Statements and Interpretations of the FASB, Accounting Principles Board (APB) Opinions, and Accounting Research Bulletins (ARBs) of the Committee on Accounting Procedure. In addition to applying FASB Statements and Interpretations, APB Opinions, and ARBs issued on or before November 30, 1989, a proprietary activity may also apply *all* FASB Statements and Interpretations issued after November 30, 1989, except those that conflict with or contradict GASB pronouncements. The same application of FASB pronouncements is encouraged to be used for all proprietary activities, including component units, in the general-purpose financial statements of the reporting entity.

GASB Statements Effective for Periods Beginning After June 15, 1994, With Early Application Encouraged

.54 *Escheat Property.* In October 1993, the GASB issued GASB Statement No. 21, *Accounting for Escheat Property,* which is effective for financial statements for periods beginning after June 15, 1994, with early application encouraged. An escheat is the reversion of property to a governmental entity in the absence of legal claimants or heirs. GASB Statement No. 21 establishes standards for the fund type to be used to report escheat property and for reporting liabilities and interfund transfers relating to escheat property.

.55 *Taxpayer-Assessed Tax Revenues.* In December 1993, the GASB issued GASB Statement No. 22, *Accounting for Taxpayer-Assessed Tax Revenues in Governmental Funds,* which is effective for financial statements for periods beginning after June 15, 1994, with early application encouraged. GASB Statement No. 22 requires revenue from taxpayer-assessed taxes, such as sales and income taxes, net of estimated refunds, to be recognized in governmental funds in the accounting period in which they become susceptible to accrual—that is, when they become both measurable and available to finance expenditures of the fiscal period.

.56 *Refundings of Debt Reported by Proprietary Activities.* In December 1993, GASB issued GASB Statement No. 23, *Accounting and Reporting for Refundings of Debt Reported by Proprietary Activities,* which is effective for financial statements for periods beginning after June 15, 1994, with early application encouraged. GASB Statement No. 23 establishes standards of accounting and financial reporting for current refundings and advance refundings resulting in defeasance of debt reported by proprietary activities. Refundings involve the issuance of new debt, the proceeds of which are used to repay previously issued debt. The proceeds may be used immediately for this purpose (current refunding), or they may be placed with an escrow agent and invested until they are used to pay principal and interest on the old debt at a future time (advance refunding).

.57 For current refundings and advance refundings resulting in defeasance of debt reported by proprietary activities, the difference between the reacquisition price and the net carrying amount of the old debt should be deferred and amortized as a component of interest expense in a systematic and rational manner over the remaining life of the old debt or the life of the new debt, whichever is shorter. On the balance sheet, the deferred amount should be reported as a deduction from or an addition to the new debt liability.

.58 In addition, GASB Statement No. 23 makes the disclosures required by paragraphs 11 through 13 of GASB Statement No. 7, *Advance Refundings Resulting in Defeasance of Debt*, applicable to current refundings reported by proprietary activities.

GASB Concepts Statement Issued

.59 *Service Efforts and Accomplishments Reporting.* In April 1994, the GASB issued GASB Concepts Statement No. 2, *Service Efforts and Accomplishments Reporting*, which further develops the objective of service efforts and accomplishments (SEA) reporting and identifies its elements as well as the characteristics SEA information should possess. GASB Concepts Statement No. 2 provides background information on the governmental environment, governmental decision making, accountability, and the reporting of performance information as part of general-purpose external financial reporting (GPEFR). The GASB recognizes the need for extensive experimentation with SEA measurement reporting and use before SEA measures are considered for inclusion as part of the information required for GPEFR. It is essential that, in addition to accountants and others involved in financial management, those in government management, internal auditors, elected officials, citizens, and other users become active in developing and using SEA measures.

Recent GASB Exposure Drafts Issued

.60 *Certain Grants and Other Financial Assistance.* In January 1994, the GASB issued an exposure draft of a proposed Statement, *Accounting and Financial Reporting for Certain Grants and Other Financial Assistance*, that would establish accounting and financial reporting standards for pass-through grants, food stamps, and on-behalf payments for fringe benefits and salaries. The GASB is expected to issue a final Statement in mid-1994. The Statement is expected to be effective for financial statements for periods beginning after June 15, 1995.

.61 *Pension Accounting.* In February 1994, the GASB issued three exposure drafts: *Financial Reporting for Defined Benefit Pension Plans and Disclosures for Defined Contribution Plans*, *Accounting for Pensions by State and Local Governmental Employers*, and *Financial Reporting for Postemployment Healthcare Plans Administered by Defined Benefit Pension Plans.* The GASB is expected to issue final Statements related to these three exposure drafts in late 1994. The Statement *Accounting for Pensions by State and Local Governmental Employers* is expected to be effective for periods beginning after December 31, 1996. The remaining two Statements are expected to be effective for periods beginning after December 31, 1995.

Other GASB Items

.62 *Applicability of GASB Standards.* In November 1993, the GASB issued a staff paper entitled "Applicability of GASB Standards," which provides advisory guidance only. It is intended to be helpful in resolving questions about whether a particular entity should follow the hierarchy of accounting standards applicable to state and local governmental entities or the hierarchy applicable to nongovernmental entities. The two hierarchies are set forth in SAS No. 69, *The Meaning of* Present Fairly in Conformity with Generally Accepted Accounting Principles *in the Independent Auditor's Report* (AU section 411).

.63 *GASB Implementation Guides.* GASB Implementation Guides are recognized in category (d) of the hierarchy of GAAP in SAS No. 69 (AU section 411). In November 1993, the GASB staff issued an Implementation

Guide to GASB Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues.* This Implementation Guide contains over one hundred questions and answers developed from technical inquiries received by the GASB staff.

.64 In addition to the questions and answers, the Implementation Guide includes an appendix that analyzes several examples of activities that may potentially be reported as public-entity risk pools. Some of these examples are based on actual situations. Furthermore, a nonauthoritative decision diagram is included to assist users in making their own determinations.

.65 The GASB staff is also in the process of preparing an Implementation Guide for GASB Statement No. 14 (see the separate discussion of GASB Statement No. 14 in the section "Reporting Entity" in paragraphs .44 and .45).

References for Additional Guidance

AICPA

.66 The following are some AICPA publications that may be of interest to auditors of state and local governmental units:

- *Checklists and Illustrative Financial Statements for State and Local Governmental Units* (No. 008504).
- *Local Governmental Audit and Accounting Manual* (No. 007303)—This manual includes sample auditor's reports, a local governmental audit program, disclosure checklists and illustrative financial statements, illustrative internal control structure questions, and a partner's engagement review program for state and local governmental units.
- *Internal Control—Integrated Framework* (No. 990002JA)—This report was commissioned by the Committee of Sponsoring Organizations of the Treadway Commission to establish a common definition of internal control that serves the needs of different parties not only for assessing their control systems, but also for determining how to improve them. A software package in WordPerfect 5.1 is also available (No. 990003JA) to help users identify and report on potential control deficiencies.

.67 *AICPA Continuing Professional Education (CPE) Courses.* The AICPA Governmental Accounting and Auditing Certificate of Educational Achievement program consists of the following series of CPE courses:

- Governmental Accounting Principles and Financial Reporting (GAA1)
- Financial Audits of Governmental Entities (GAA2)
- Auditing and Reporting Under *Government Auditing Standards* (GAA3)
- Auditing Under the Single Audit Act (GAA4)

On successful completion of the program, the participant is awarded a certificate.

.68 In addition, the AICPA offers group study and self-study courses. Group study courses include the following:

- Accounting for Governmental Units Under GASB
- Audit Requirements of OMB Circular A-133
- Audits of HUD-Assisted Projects
- Advanced Auditing of HUD-Assisted Projects
- Advanced Accounting for Governmental Units Under GASB

- Compliance Auditing
- Government Auditing and Accounting Update
- How to Communicate Material Noncompliance and Material Internal Control Weaknesses
- Intermediate Auditing of Federal, State and Local Compliance Requirements
- Yellow Book: *Government Auditing Standards*

Self-study courses include the following:

- Introduction to Governmental Accounting
- Performing a Single Audit
- Audits of State and Local Governmental Units
- Understanding Federal Audit Policies and Procedures
- Working With the 1988 Revised Yellow Book on *Government Auditing Standards*
- Audit Requirements of OMB Circular A-133
- Audits of HUD-Assisted Projects
- Advanced Auditing of HUD-Assisted Projects
- Selected Readings in Governmental and Nonprofit Accounting and Auditing
- Accounting and Auditing for Certain Nonprofit Organizations
- Governmental Accounting and Auditing Update

For more information about AICPA CPE courses, call the AICPA information hotline at (800) 862–4272.

GASB

.69 The GASB offers the following publications and services:

- *Codification of Governmental Accounting and Financial Reporting Standards,* as of June 30, 1993 (GCD93). An edition as of June 30, 1994, is expected to be issued in August 1994.
- *GASB Original Pronouncements,* as of June 30, 1993 (GOP93). An edition as of June 30, 1994, is expected to be issued in August 1994.
- GASB Implementation Guides. These question-and-answer special reports are an occasional service containing implementation guidance for GASB standards.
- *GASB Action Report.* A monthly newsletter.
- Governmental Accounting Research System. An information-based software package that allows research on GASB literature.

GASB publications and services can be obtained by calling the GASB Order Department at (203) 847–0700, extension 10.

Single Audit Information Service

.70 The *Single Audit Information Service* is a loose-leaf reference service offered by the Thompson Publishing Group. It explains how to implement the single audit and provides an update of current events in the governmental audit community. The *Single Audit Information Service* can be ordered by calling the Thompson Publishing Group at (800) 677–3789.

Federal Agencies—Administrative Regulations

.71 Most federal agencies issue general administrative regulations that apply to their programs. These regulations provide general rules on how to apply for grants and contracts, how grants are made, the general conditions that apply to and the administrative responsibilities of grantees and contractors, and the compliance procedures used by the various agencies. The regulations are included in the Code of Federal Regulations.

.72 In 1988, a final rule, *Uniform Administrative Requirements for Grants and Cooperative Agreements With State and Local Governments,* was published, establishing a *common rule* to create consistency and uniformity among federal agencies in the administration of grants to and cooperative agreements with state, local, and federally recognized Indian tribal governments. The common rule has been codified in each federal agency's portion of the Code of Federal Regulations.

.73 It should also be noted that federal agencies have also codified and revised OMB Circular A-128 in each agency's portion of the Code of Federal Regulations. Although the OMB *Compliance Supplement for Single Audits of State and Local Governments* sets forth the compliance requirements for programs contributing a great majority of funding to state and local governments, federal agencies also develop specific compliance supplements for use in auditing programs not included in the OMB document. These can be obtained directly from the regional office of the appropriate federal agency.

.74 Auditors should also be aware that many agencies have program-specific and other audit requirements that are not covered by OMB Circular A-128. Such requirements may relate to certain programs (such as student financial assistance or HUD-insured mortgage programs), as well as to contract audit requirements.

GAO

.75 GAO publications include the following:

- *Government Auditing Standards*—The standards relate to audits of governmental organizations, programs, activities, and functions and of governmental funds received by contractors, nonprofit organizations, and other nongovernmental organizations. The standards incorporate the AICPA Statements on Auditing Standards but prescribe additional standards needed to meet the more varied interests of users of reports on governmental audits. Revised standards are expected in June 1994 and will be available from the Government Printing Office, Superintendent of Documents, Washington, DC 20401 (020–000–00–265–4).
- *Interpretation of Continuing Education and Training Requirements*—This provides guidance to audit organizations and individual auditors on implementing the CPE requirements of *Government Auditing Standards* (April 1991, 020–000–00250–6). This interpretation is available from the Government Printing Office, Superintendent of Documents, Washington, DC 20401.
- *Assessing Compliance With Applicable Laws and Regulations*—This booklet, issued by the GAO Office of Policy, is intended to help the auditor implement requirements for detecting noncompliance (December 1989, GAO/OP-4.1.2).
- *Assessing the Reliability of Computer-Processed Data*—This guidebook is intended mainly for auditors and evaluators, not for experts in data processing. It provides some guidelines on what auditors must do to satisfy the standards of *Government Auditing Standards. Government Auditing Standards* requires auditors to satisfy themselves that computer-processed data are relevant and reliable (September 1990, GAO/OP-8.1.3).

- *Assessing Internal Controls in Performance Audits*—This guidebook relates specifically to performance audits (September 1990, GAO/OP-4.1.4).
- *Guide to Federal Agencies' Procurement of Audit Services from Independent Public Accountants (IPA)*—This booklet provides a basic understanding of how IPA contracts should be awarded to officials unfamiliar with federal procurements. It discusses the special requirements of the Chief Financial Officers (CFO) Act (April 1991, GAO/AFMD-12.19.3).
- *How to Get Action on Audit Recommendations*—This guide is intended to help auditors get more action and better results from their audit work on governmental programs and operations (July 1991, GAO/OP-9.2.1).

Requests for copies of these booklets should be sent to the U.S. General Accounting Office, P.O. Box 6015, Gaithersburg, MD 20877. The telephone number is (202) 275–6241.

Office of Management and Budget—Circulars

.76 In consultation with grant-making agencies, the GAO, and representatives of grant recipients, the OMB developed a series of financial circulars that establish uniform policies and rules to be observed by all executive-branch agencies of the federal government. Circulars and other documents relevant to audits of state and local governmental units are listed below. For copies of circulars and bulletins, write or call the Executive Office of the President, Publications Office, Room 2200, New Executive Office Building, Washington, DC 20503; telephone, (202) 395–7332. For compliance supplements and the *Catalog of Federal Domestic Assistance*, write or call the Government Printing Office, Room 2200, New Executive Office Building, Washington, DC 20503; telephone, (202) 783–3238. Orders may also be faxed to (202) 512–2250.

OMB Circulars Relevant to Audits of State and Local Governments

Circular Number	*Applicability*	*Issue Date*
A-21 (Revised)	Cost principles for educational institutions	July 1993
A-87 (Revised)	Cost principles for state and local governments	January 1981
A-102 (Revised)	Grants and cooperative agreements with state and local governments	March 1988
A-128	Audits of state and local governments (see also related question-and-answer document under "Office of Management and Budget—Other Guidance")	April 1985
A-133	Audits of institutions of higher education and other nonprofit institutions	March 1990

Office of Management and Budget—Other Guidance

.77 *The Catalog of Federal Domestic Assistance* is a government-wide compendium of federal programs, projects, services, and activities that provide assistance or benefits to the American public. The General Services Administration (GSA) is responsible for the dissemination of federal domestic assistance information through the Catalog and maintains the information database from which program information is obtained. The OMB serves as an intermediary between other federal agencies and the GSA, thus providing oversight relative to the collection of federal domestic assistance program data. The Catalog may be purchased from the Government Printing Office by calling (202) 783–3238.

.78 Program information provided by the Catalog includes authorizing legislation and audit requirements. The GSA distributes copies to specified national, state, and local governmental offices. Catalog staff may be contacted at (202) 708–5126.

.79 Program information is also available on machine-readable magnetic tape. The tape may be purchased by writing the Federal Domestic Assistance Catalog Staff, General Services Administration, Ground Floor, Reporters Building, 300 Seventh Street, S.W., Washington, DC 20407, or calling (202) 708–5126.

.80 Other publications include the following:

- *Compliance Supplement for Single Audits of State and Local Governments*—This sets forth the major federal compliance requirements that should be considered in a single audit of state and local governments that receive federal assistance. It supplements OMB Circular A-128. The latest revision, which includes the three new general requirements, was issued in September 1990, although a new revision is expected in August 1994. This supplement may be purchased from the Government Printing Office by calling (202) 783–3238. The stock number is 041–001–00356–8.

- *Questions and Answers on the Single Audit Provisions of OMB Circular A-128,* Audits of State and Local Governments—This document provides guidance on the single audit process through a series of questions and answers. The document is available from the Executive Office of the President, Publications Office, at (202) 395–7332, and is also included as an appendix to the revised AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units.*

- *Compliance Supplement for Audits of Institutions of Higher Learning and Other Non-Profit Institutions*—This supplements OMB Circular A-133 and sets forth the major compliance requirements that should be considered in an organization-wide audit of universities and other nonprofit institutions that receive federal assistance. This supplement may be purchased from the Government Printing Office by calling (202) 783–3238. The stock number is 041–001–00374–6. Information regarding the two compliance supplements may be obtained by contacting the OMB Financial Standards and Reporting Branch at (202) 395–3993.

PCIE Subcommittee Guidance

.81 The PCIE Standards Subcommittee publishes supplemental, nonauthoritative guidance for federal officials dealing with issues arising from the implementation of the Single Audit Act; OMB Circular A-128, which implements the Act; and OMB Circular A-133, which extends the single audit concept to institutions of higher education and other nonprofit institutions.

.82 The PCIE Standards Subcommittee has issued the following position statements:

- PCIE Statement No. 1 provides guidance on determining when a series of audits of individual federal departments, agencies, and establishments may be considered an audit for purposes of the Single Audit Act.

- PCIE Statement No. 2 provides guidance to cognizant agencies on determining whether an audit report that does not meet the 50 percent rule on internal control coverage prescribed in the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units* should be accepted.

- PCIE Statement No. 3 provides guidance on using a cyclical approach to internal control reviews of nonmajor programs.

- PCIE Statement No. 4 establishes uniform procedures for referrals of substandard audits to state boards of accountancy and the AICPA.

- PCIE Statement No. 5 provides guidance for certain not-for-profit entities other than institutions of higher education or hospitals not covered by OMB Circular A-110, *Uniform Administrative Requirements for Grants and Other Agreements With Institutions of Higher Education, Hospitals, and Other Nonprofit Organizations.*

- PCIE Statement No. 6 provides clarifications and additional practical working guidance to Inspectors General and others participating in audits of not-for-profit organizations performed under OMB Circular A-133. It contains questions and answers on OMB Circular A-133 and was developed from questions frequently asked.

.83 Position Statement Nos. 1 through 5 are available from the U.S. Department of Education, Office of the Inspector General, Technical and Nonfederal Audit Staff, 400 Maryland Avenue, S.W., Washington, DC 20202–1510. Position Statement No. 6 (stock number 041–001–00374–6) is available from the Government Printing Office, Superintendent of Documents, Mail Stop: SSOP, Washington, DC 20402–9328. The PCIE has also issued the following:

- *Uniform Desk Review Guide of A-128 Single Audits* (PCIE–06–056)
- *Uniform Quality Control Review Guides for A-128 Single Audits* (PCIE–06–057)
- *Revised Program Audit Guide Listing* (stock number 065–000–00585–9)
- *Study on Improving the Single Audit* (stock number 065–000–0615–4)

Copies of the *Uniform Desk Review Guide* and the *Uniform Quality Control Guide* are available from the U.S. Department of Commerce, National Technical Information Service, Springfield, VA 22161. The *Revised Program Audit Guide Listing* and the *Study on Improving the Single Audit* are available from the GPO at the above address.

Government Finance Officers Association

.84 The address and telephone number of the Government Finance Officers Association (GFOA) are 180 N. Michigan Avenue, Suite 800, Chicago, IL 60601–7476; (312) 977–9700. GFOA publications include the following:

- *Governmental Accounting, Auditing, and Financial Reporting (GAAFR)*—*GAAFR* provides nonauthoritative guidance and includes implementation guidance on the practical application of GAAP for governments. It also includes implementation guidance on the many pronouncements of the GASB, detailed journal entries and explanations that cover a multitude of common and complex transactions, a complete sample comprehensive annual financial report, discussion and illustration of single audit requirements, a glossary and chart of accounts, and a detailed index. (The *GAAFR Study Guide* is also available.)
- *Audit Management Handbook*—This handbook on audit management is intended for state and local governments and CPA firms that are involved in obtaining or performing financial audits. It provides information on all aspects of the audit management process, including establishing the scope of the audit, procuring the audit (including model requests for proposal), monitoring the audit, and resolving audit issues and findings.
- *Financial Reporting Series*—This set of books contains information and examples of how governments present specific financial reporting information. It includes—
  - *Illustrations of Notes to the Financial Statements of State and Local Governments* (1983).
  - *Illustrations of Introductory Sections of Comprehensive Annual Financial Reports of State and Local Governments* (1984).
  - *Illustrations of Statistical Sections of Comprehensive Annual Financial Reports of State and Local Governments* (1985).
  - *Illustrations of Supplementary Financial Data in Comprehensive Annual Financial Reports of State and Local Governments* (1985).
  - *Illustrations of Interim Financial Statements of State and Local Governments* (1985).
  - *How to Understand Local Government Financial Statements: A User's Guide* (1986).

- *Illustrations of Combined, Combining, and Individual Fund and Account Group Financial Statements of State and Local Governments* (1986).
- *Suggested Solutions to Governmental Accounting and Financial Reporting Practice Problems in Applying Authoritative Standards* (1987).
- *Illustrations of Popular Reports of State and Local Governments* (1988).
- *A Public Manager's Guide to Government Accounting and Financial Reporting* (1989).

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.85 This Audit Risk Alert supersedes *State and Local Governmental Developments—1993.*

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.86 Auditors should also be aware of the economic, regulatory, and professional developments that may affect the audits they perform, as described in *Audit Risk Alert—1993* [AAM section 8010].

AAM Section 8080
Agribusiness Industry Developments—1993

Industry and Economic Developments

.01 Agriculture is one of the most productive and globally competitive sectors of the United States economy. More than 16 percent of the gross national product comes from the soil. Productivity in the agricultural sector has been increasing faster than demand, and this growth has been accomplished with fewer farmers and fewer acres under cultivation. The overall economic climate, lower farm asset values, reduced farm income, farm acreage out of production, inclement weather, and revolutionary new farming practices such as conservation tillage, have all affected agricultural producers and agricultural cooperatives.

.02 As a result of the floods in the Midwest, many commodity products, such as corn and soybeans, have been in short supply, driving prices up. For many producers, corn and soybean production for 1993 is expected to be down approximately 22 percent and 13 percent, respectively. Due to sophisticated hedging programs that lock in prices far ahead of harvest, most producers will show little impact on their bottom line in 1993. Other producers are so diversified that price increases for some products will have little effect on earnings. Seed companies' earnings may be negatively affected in 1993, as farmers return seeds they were unable to plant due to the weather, or fail to pay for seeds that were planted but never harvested.

.03 U.S. consumption patterns of meat and poultry have changed in recent years in response to dietary concerns. Consumers are eating more poultry and fish and less red meat. In an effort to remain profitable, the red meat industry has been closing inefficient plants and introducing product innovations. Red meat companies are also responding to changes in demand by expanding into other product areas, such as poultry, through mergers, acquisitions, and joint ventures. The poultry industry continues to experience growth as consumers demand more ground turkey, chicken nuggets, and other value-added, convenience-type poultry products. However, although the overall poultry industry is growing, the number of establishments has been declining due to mergers and acquisitions.

.04 In the dairy industry, consumers are seeking nonfat and low-fat products. This trend is evident in the growth of yogurt products. As consumers continue to seek lower-fat alternatives to whole milk, the production of low-fat and skim milk should continue to rise. Some dairy companies are trying to draw consumers from competing, nondairy beverages by improving the taste of skim milk.

.05 Auditors should be aware of practices that may expose agricultural producers and cooperatives to high levels of risk. The various risks associated with these practices may be significant, and auditors should consider whether agricultural producers and cooperatives are involved in sophisticated hedging programs, downsizing, innovative financing arrangements, or research and development projects.

Regulatory Developments

New Marketing Loan Provisions—Agricultural Producers

.06 Marketing loan provisions provide an alternative method for repaying Commodity Credit Corporation (CCC) nonrecourse loans. CCC loans allow producers who participate in commodity programs to use their commodities as collateral for loans. Producers often take out CCC nonrecourse loans to obtain short-term financing, and most often do so at harvest or soon thereafter.

.07 CCC nonrecourse loans provide producers with ready cash, and allow them to hold commodities until later in the marketing year when prices may be higher than traditional harvest-time lows. CCC loans serve this function regardless of relative levels of loan rates and market prices. The loan program also helps provide income support, and at times has provided price support to producers.

.08 For the first time, marketing loan provisions are available to eligible wheat and feed grain producers, beginning with the 1993 crop year. The impetus for this action was the Omnibus Budget Reconciliation Act of 1990, which required the Secretary of Agriculture to implement marketing loan provisions for 1993-1995 wheat and feed grain crops if a General Agreement on Traffic and Trade (GATT) accord was not signed by June 30, 1992. As of August 1993, no GATT accord had been signed.

.09 Marketing loan provisions are designed to help minimize potential loan forfeitures and accumulation of government stocks when prices are low relative to CCC loan rates. This helps keep CCC loan programs from interfering with markets, and provides additional income support to producers when prices are low.

.10 Although marketing loan provisions were available for rice and cotton beginning in 1985 and for soybeans and minor oilseeds beginning in 1991, prices have not always been low enough for many producers to receive payments, and only rice producers have consistently received benefits. However, as of mid-1993, low wheat prices have already resulted in benefits to some wheat producers.

.11 Producers must meet certain criteria to be eligible for marketing loan benefits. Crops eligible for marketing loan gains due to the GATT trigger provisions include wheat and feed grains (corn, grain sorghum, barley, oats, and rye). Rice has been eligible for marketing loans since the 1985-1986 crop year, cotton since 1986-1987, and soybeans and minor oilseeds since 1991-1992.

.12 Under the wheat and feed grain provisions, a producer must participate in the commodity program for that crop, and comply with all acreage reduction requirements. The wheat or feed grain crops, except for rye, must be produced on program-permitted acreage or flex acres, and the producer must ensure that the grain meets the requirements of CCC minimum grade and quality standards.

.13 In addition, the producer must have beneficial interest in the commodity on the date the price-support loan or loan deficiency payment is requested. This means that the following criteria must be met:

1. *Control of the commodity.* The producer must retain the ability to make all decisions affecting the commodity, including movement, sale, and the request for a loan or a loan deficiency payment.

2. *Risk of loss.* The producer must be responsible for loss or damage to the commodity.

3. *Title to the commodity.* The producer must not have sold or delivered the commodity or warehouse receipt to a buyer.

Once beneficial interest in the commodity is lost, the commodity loses eligibility for a loan or a loan deficiency payment at any time in the future. Auditors of wheat and feed grain producers should be aware of these marketing loan provisions and should carefully consider their impact on the financial statements of producers.

Environmental Matters

.14 The Environmental Protection Agency (EPA) is empowered by law to seek recovery from anyone who ever owned or operated a particular contaminated site, or anyone who ever generated or transported hazardous materials to such a site. Agricultural producers and cooperatives commonly use herbicides and pesticides, and engage in activities, such as maintenance of underground storage tanks, that may create environmental cleanup activities. *Audit Risk Alert—1993* [AAM section 8010] includes a detailed discussion on accounting for and disclosure of environmental cleanup costs.

Income Tax Developments

.15 In a recent letter to the U.S. Department of Agriculture, the Internal Revenue Service (IRS) took the position that farmers who use futures or options to hedge the value of their crops must treat those instruments as capital assets for income tax purposes. According to recent studies, between 20 and 30 percent of U.S. farmers now hedge their crop prices in the futures market. Farmers' losses on such hedges have always been considered ordinary business expenses. Auditors of agricultural producers and cooperatives involved in these hedging activities should consider this IRS position when auditing the client's income tax accrual and tax payable balances.

Audit Issues

Inventory

.16 Inventory is generally a significant asset on the balance sheet (usually the most significant current asset) of an agricultural producer or cooperative. Since an agricultural producer or cooperative is essentially a manufacturer, auditors should be aware that an agricultural producer or cooperative's inventory often has a higher inherent risk and produces greater complexities for auditors than do inventories of other businesses. AICPA Statement of Position 85-3, *Accounting by Agricultural Producers and Agricultural Cooperatives*, provides specific guidance on the generally accepted accounting principles (GAAP) relating to accounting for inventories of agricultural producers and cooperatives. Auditors of agricultural producers or cooperatives should pay special attention to the following areas of inventory accounting that may affect audit risk:

- Whether the agricultural producer or cooperative has established an adequate internal control structure over the inventory, for example, a control structure that safeguards physical quantities and provides accurate quantity and cost data
- Whether all purchases and receipts are properly authorized and recorded
- Whether payroll records are sophisticated enough that labor costs may be allocated to the appropriate inventory component
- Whether all direct and indirect costs of developing animals are accumulated until the animals' maturity, at which point the accumulated development costs are depreciated over the animals' estimated productive life
- Whether agricultural cooperatives are appropriately determining the passing of title for products received from patrons without payment of a set price to the patron
- Whether land development costs (costs incurred getting land ready for production), are being appropriately capitalized by the agricultural producer or cooperative

Auditors of agricultural producers and cooperatives may consider engaging a specialist to evaluate the quality or value of inventory. In these cases, auditors should follow the guidance of AICPA Statement on Auditing Standards (SAS) No. 11, *Using the Work of a Specialist* (AU section 336). Other general guidance on auditing inventory can be found in the AICPA Auditing Procedure Study, *Audit of Inventories* (Product No. 021045).

Research and Development Costs

.17 Some agricultural producers and cooperatives may be involved in research and development programs in attempts to create different products or improve those that exist. Auditors of these agricultural producers and cooperatives should consider whether these costs have been appropriately accounted for and disclosed. Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 2, *Accounting for Research and Development Costs* (AC R50), requires that research and development costs be charged to expense when incurred. FASB Statement No. 2 (AC R50) also requires disclosure in the financial statements of the total research and development costs charged to expense in each period for which an income statement is presented.

Derivatives and Other High-Risk Investments

.18 Recent years have seen a growing use of innovative financial instruments that often are very complex and can involve a substantial risk of loss. Both agricultural producers and cooperatives regularly enter into forward contracts, futures contracts, and options in order to hedge against inventory losses. These off-balance-sheet instruments are complex financial instruments whose values depend on the volatility of interest rates, foreign currency indexes, and commodity and other prices.

.19 *Accounting.* Accounting for derivatives is complex. Given the constant innovation and complexity of derivatives, accounting literature does not explicitly cover some derivatives, however, several related projects are underway.

.20 The FASB has been carrying out a major project on the recognition and measurement of financial instruments, which has already resulted in the issuance of FASB Statements No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (AC F25), No. 107, *Disclosures about Fair Values of Financial Instruments* (AC F25), and No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (AC I80), and FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts* (AC B10), that address related issues. The FASB's project includes a comprehensive review of accounting for hedging and risk-adjusting derivatives. Also, the International Accounting Standards Committee is in the process of developing an international accounting standard for financial instruments.

.21 Several accounting issues involving derivatives have also been addressed by the FASB's Emerging Issues Task Force. Other guidance is provided by FASB Statements No. 52, *Foreign Currency Translation* (AC F60), and No. 80, *Accounting for Futures Contracts* (AC F80). In addition, AICPA Issues Paper No. 86-2, *Accounting for Options,* discusses various matters related to options.

.22 *Auditing.* The innovative and complex nature of such investment vehicles may significantly increase audit risk. For example, as more and more entities enter the markets for such instruments, their profitability may diminish. Traders may attempt to compensate for the diminution by increasing the volume of transactions involving such instruments or by further customizing products. An increase in volume may be accompanied by trading with counterparties that have higher credit risk. Customizing transactions may increase valuation difficulties. The propriety of the methods used by the managements of agricultural producers and cooperatives to account for transactions involving sophisticated financial instruments and to determine their value should be carefully considered. Understanding the substance of transactions in such instruments is important in determining the propriety of their accounting treatment. In some circumstances, auditors may find it helpful to consult with experts.

.23 SAS No. 22, *Planning and Supervision* (AU section 311), requires that auditors understand the events, transactions, and practices that, in their judgment, may have a significant effect on the entity's financial statements. Accordingly, auditors should carefully consider the various risks involved with investments in derivatives and other complex securities as they plan their audits and should—

1. Assess management's expertise in monitoring, evaluating, and accounting for the securities.
2. Ensure that the entity has set appropriate policies and procedures for investment in high-risk securities and that there is adequate oversight by the board of directors.
3. Involve specialists, when necessary, in valuing and auditing these investments.

Service-Center-Produced Records

.24 Many agricultural producers and cooperatives use outside service organizations to perform tasks requiring expertise or technology that does not exist within the organization. Service organizations provide various levels of services ranging from performing a specific task under the direction of an agricultural producer or cooperative to replacing entire business units or functions of the agricultural producer or cooperative. SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AU section 324), which was issued in April 1992 and superseded SAS No. 44, *Special-Purpose Reports on Internal Accounting Control at Service Organizations*, provides guidance to auditors of agricultural producers or cooperatives and to service auditors performing procedures and reporting on the control policies and procedures at a service organization. *Audit Risk Alert—1993* [AAM section 8010] contains a more detailed discussion of SAS No. 70 (AU section 324). Also, the AICPA's Auditing Standards Division plans to issue an Auditing Procedure Study, *Implementing SAS No. 70, Reports on the Processing of Transactions by Service Organizations*, in the first quarter of 1994.

Innovative Financing Methods

.25 In today's competitive market, many new and innovative financing methods are growing in popularity. Auditors of agricultural producers and cooperatives should be aware of such methods as limited partnerships, joint ventures, member-employee loan programs, special assessments, deferred-payment programs, nonfarm credit financing, and employee equity participation.

.26 These financing methods could affect an audit of an agricultural producer or cooperative in a number of ways, including an increase in the following:

- Number of audit procedures, for example, reading partnership agreements, analyzing and substantiating changes in partnership or joint venture capital
- Amount of audit work performed on equity and income taxes, in the case of partnerships
- Testing of internal controls when the producer or cooperative is invested in an unaudited partnership or joint venture
- Payroll testing in instances of employee equity participation

.27 In cases of innovative financing methods, the overall audit risk will usually increase, resulting in the need to alter the nature and increase the extent of audit procedures. If auditors do not have the proper expertise in this area, they should consider using an outside specialist for these transactions.

Compensation Methods

.28 Some agricultural producers and cooperatives have been paying wages in the form of commodities to avoid the payment of some Social Security taxes. This policy is currently being investigated by the IRS and could result in some agricultural producers and cooperatives paying additional taxes plus interest and penalties. Auditors may consider extending their payroll auditing procedures for this type of compensation and may also consider following the progress of the IRS investigation to determine whether there is a need for a loss-contingency accrual.

.29 Auditors should also consider whether the fair value of any services provided as compensation expense is recorded in the financial statements.

Agricultural Producers' Financial Statements

.30 In May 1991, the Farm Financial Statements Task Force released a report, *Recommendations of the Farm Financial Statements Task Force*, the purpose of which was to standardize financial reporting for farmers. Auditors should be aware that these recommendations do not constitute GAAP, nor do they have the substantial support required to constitute a comprehensive basis of accounting other than GAAP. Auditors who report on financial statements prepared in conformity with such recommendations should consider whether a qualified or adverse opinion should be issued because of departures from GAAP as described in SAS No. 58, *Reports on Audited Financial Statements*, paragraphs 49 through 69 (AU section 508.49—.69).

Accounting Issues and Developments

Hedging Activities

.31 Both agricultural producers and cooperatives enter into futures as a means of hedging exposure to certain risks. In order for futures contracts to qualify as hedges in accordance with FASB Statement No. 80, *Accounting for Futures Contracts* (AC F80), the following conditions must be met:

- The item or group of items intended to be hedged must contribute to the price or interest rate risk of the agricultural producer or cooperative.
- There must be a high correlation of changes in the market value of the futures contracts, and the fair value of, or interest income, or expense associated with, the hedged items shall be probable so that the results of the futures contract will substantially offset the effects of price or interest changes on the exposed items.

Auditors should consider whether management's designation of futures contracts as hedges is appropriate in light of the criteria set forth in FASB Statement No. 80 (AC F80).

.32 As they evaluate the propriety of presentation and disclosure of hedging activities in the financial statements, auditors should be aware that FASB Statement No. 104, *Statement of Cash Flows—Net Reporting of Certain Cash Receipts and Cash Payments and Classification of Cash Flows from Hedging Transactions* (AC C25), states that the cash flows from hedging transactions should be classified as operating cash items in the statement of cash flows and disclosed as a separate line item if material.

Disposal of Business Segments

.33 As discussed earlier, some sectors of the industry may be in the process of downsizing their operations, for example, red meat producers may be closing inefficient plants. If an agricultural producer or cooperative is accounting for the closing as a disposal of a segment, the auditor should consider whether the plant being closed meets the criteria to be considered a segment under Accounting Principles Board Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions* (AC I13). If it is determined that the plant closing constitutes a disposal of a segment, the auditor should consider, among other things, whether management has—

- Disclosed the results of operations of the disposed segment, less applicable income taxes, as a separate component of income before extraordinary items.
- A disposal plan which includes, at a minimum, identification of the major assets to be disposed of, the expected method of disposal, the period expected to be required for completion of the disposal, an active program to find a buyer if the disposal is to be by sale, and the estimated results of operations of the segment from the measurement date to the disposal date.
- Recorded an estimated loss at the measurement date, if the disposal is expected to result in a loss.
- Recognized any gain upon realization, usually the date of disposal.
- Appropriately calculated the gain or loss from the disposal, not including expenses associated with normal business activities.

.34 The auditor should also consider whether the agricultural producer or cooperative has disclosed the following in the notes to the financial statements for the period encompassing the measurement date:

- The identity of the segment of business that has been or will be discontinued
- The expected disposal date, if known
- The expected manner of disposal
- A description of the remaining assets and liabilities of the segment at the balance sheet date
- The income or loss from operations and any proceeds from the disposal of the segment during the period from the measurement date to the date of the balance sheet date

AICPA Audit and Accounting Literature

Audit and Accounting Guide

.35 The AICPA Audit and Accounting Guide *Audits of Agricultural Producers and Agricultural Cooperatives* is available through the AICPA's loose-leaf subscription services. In the loose-leaf service, conforming changes (those necessitated by the issuance of new authoritative pronouncements) and other minor changes that do not require due process are incorporated periodically. Paperback editions of the guides as they appear in the service are printed annually.

Agricultural Cooperatives' Financial Reporting Checklist

.36 The AICPA's Technical Information Service has published a revised version of *Checklists and Illustrative Financial Statements for Agricultural Cooperatives* as a tool for preparers and reviewers of financial statements of agricultural cooperatives.

Technical Practice Aids Publication

.37 *Technical Practice Aids* is an AICPA publication that, among other things, contains questions received by the AICPA's Technical Information Service on various subjects and the service's responses to those questions. *Technical Practice Aids* contains questions and answers specifically pertaining to agricultural cooperatives. *Technical Practice Aids* is available both as a subscription service and in hardback form. Order information may be obtained from the AICPA Order Department.

* * * *

.38 This Audit Risk Alert replaces *Agribusiness Industry Developments—1992* [AAM section 8015].

* * * *

.39 Practitioners should also be aware of the economic, regulatory, and professional developments in *Audit Risk Alert—1993* [AAM section 8010] and *Compilation and Review Alert—1993.*

[The next page is 8205.]

AAM Section 8090
Airline Industry Developments—1992

Industry and Economic Developments

Continued Operating Losses

.01 The airline industry, which incurred record losses in 1990 and 1991, has continued to generate record losses in 1992. The year began with a number of positive factors, such as increased traffic and declining fuel prices, that promised healthier returns. The situation quickly changed in the second quarter, however, as the economy continued to flounder and traffic steadily declined. To increase traffic, airlines introduced new fare structures and reduced rates. Although these promotional programs succeeded in enticing ticket purchases, the drastic fare cuts resulted in continuing losses for most airlines. These losses may jeopardize the continued existence of weaker airlines, especially those currently operating in bankruptcy.

.02 International fare cuts and increasing fuel prices have also caused continued operating losses in 1992. Although international flights have traditionally been a source of solid profits for the industry, recent fare cuts have eroded any profits that would have offset domestic fare losses. In addition, fuel prices have started to rise, resulting in projections of increased operating expenses for the remainder of the year.

Antitrust Claims

.03 In June 1992, American, Delta, United, and USAir agreed to a proposal to pay $412.5 million to settle charges that alleged that the airlines used their fare-publishing service to communicate and limit price competition. Northwest and TWA have also agreed to proposed settlements on similar allegations. The proposed settlements are subject to approval by the United States District Court in Atlanta. Passengers who flew through any one of twenty-three major hub airports between January 1, 1988, and June 30, 1992, are entitled to participate in the proposed settlement, which would be paid in the form of discount certificates toward future flights.

International Developments

.04 The three largest domestic carriers, American, United, and Delta, have significantly expanded their presence in international markets over the last two years. International flights have historically provided healthy profits for the industry, and the airlines hope to increase these profits with expanded international routes.

Regulatory and Legislative Developments

Passenger Facility Charges

.05 The Federal Aviation Administration (FAA) issued final rules establishing a passenger facility charge (PFC) program in 1991. The PFC program authorizes local airport authorities to impose specified per-passenger charges at commercial-service airports to finance airport improvements. Beginning in 1992, the rules require carriers (including non-U.S. airlines) that collect more than 50,000 passenger facility charges to provide for an annual audit of their PFC accounts. Auditors engaged to audit PFC accounts are required to report "on the fairness and reasonableness of the carrier's procedures for collecting, holding, and disbursing PFC revenue." In addition, auditors are required to report whether the quarterly reports that must be filed by the carriers "fairly represent the net transaction in the PFC account." The AICPA has worked with the FAA and industry representatives to develop the following illustrative reports that satisfy both existing professional literature and the FAA's requirements.

.06

Illustrative Report on PFC Schedules

Independent Auditor's Report

XYZ Airline, Inc.:

We have audited the accompanying Schedules of Passenger Facility Charges Collected, Withheld, Refunded/Exchanged, and Remitted by XYZ Airline, Inc. (the Company) for the year and each quarter during the year ended December 31, 199X (the Schedules). The Schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on the Schedules 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 Schedules are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the Schedules. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the Schedules. We believe that our audit provides a reasonable basis for our opinion.

The Schedules were prepared for the purpose of complying with the regulations issued by the Federal Aviation Administration of the U.S. Department of Transportation to implement Sections 9110 and 9111 of the Aviation Safety and Capacity Expansion Act of 1990. Those regulations define collection as the point when agents or other intermediaries remit passenger facility charges to the airlines. Accordingly, our audit did not encompass tests of the underlying documentation supporting the reports submitted by such agencies and intermediaries to the Company.

In our opinion, the Schedules referred to above present fairly, in all material respects, the passenger facility charges collected, withheld, refunded/exchanged, and remitted by XYZ Airline, Inc. for the year and each quarter during the year ended December 31, 199X, as defined in regulations issued by the Department of Transportation.

This report is intended solely for the information and use of the Board of Directors and management of XYZ Airline, Inc. and the appropriate airport authorities. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

[*Signature*]
[*Date*]

.07

Illustrative Report on PFC Internal Controls

Two reporting options are available:

A. *Report on System of Internal Accounting Control Used in Administering Passenger Facility Charges* (*SAS No. 30* * [AU section 642])

Independent Auditor's Report

XYZ Airline, Inc.:

We have made a study and evaluation of the system of internal accounting control of XYZ Airline, Inc. (the Company) used in administering passenger facility charges collected, withheld, refunded/exchanged, and remitted for the purpose of complying with the regulations issued by the Federal Aviation Administration of the U.S. Department of Transportation to implement sections 9110 and 9111 of the Aviation Safety and Capacity Expansion Act of 1990. Our study and evaluation was conducted in accordance with standards established by the American Institute of Certified Public Accountants.

The system of internal accounting control of XYZ Airline, Inc. used in administering the processing of passenger facility charges consists of policies and procedures to process remittances of passenger facility charges received from agents or other intermediaries and to reasonably assure collection of the appropriate passenger facility charges collected directly from passengers by XYZ Airline, Inc. The system of internal accounting control also consists of policies and procedures to reasonably assure that such amounts collected are recorded properly in the Company's accounting records and that remittances are forwarded to the appropriate airport authority. Our study included tests of compliance with such policies and procedures during the period from January 1, 199X through December 31, 199X.

The management of XYZ Airline, Inc. is responsible for establishing and maintaining a system of internal accounting control to administer the passenger facility charges it collects. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of control procedures. The objectives of a system are to provide management with reasonable, but not absolute, assurance that passenger facility charges are collected, withheld, refunded/exchanged, and remitted in accordance with the rules referred to above and are recorded properly to permit the preparation of the Schedules of Passenger Facility Charges Collected, Withheld, Refunded/Exchanged, and Remitted in accordance with those rules.

Because of inherent limitations in any system of internal accounting control, errors or irregularities may occur and not be detected. Also, projection of any evaluation of the system to future periods is subject to the risk that procedures may become inadequate because of changes in conditions, or that the degree of compliance with the procedures may deteriorate.

We were not engaged to perform, nor have we performed, a study and evaluation of the Company's overall system of internal accounting control, the objective of which would be to express an opinion on whether the system, taken as a whole, meets the objectives of internal accounting control. Accordingly, we do not express such an opinion.

In our opinion, the system of internal accounting control of XYZ Airline, Inc. used in administering passenger facility charges collected, withheld, refunded/exchanged, and remitted by the Company in effect during the period from January 1, 199X through December 31, 199X, taken as a whole, was sufficient to meet the objectives stated above insofar as those objectives pertain to the prevention or detection of errors or irregularities in amounts

* This report format follows the guidance provided in Statement on Auditing Standards (SAS) No. 30, *Reporting on Internal Accounting Control* (AU section 642). On April 20, 1992, the AICPA issued an exposure draft of a proposed Statement on Standards for Attestation Engagements, *Reporting on an Entity's Internal Control Structure Over Financial Reporting.* The Statement would supersede SAS No. 30 (AU section 642) and would eliminate this report as an acceptable reporting alternative. A final Statement is expected to be issued in 1993.

that would be material in relation to the Schedules of Passenger Facility Charges Collected, Withheld, Refunded/Exchanged, and Remitted.

This report is intended solely for the information and use of the Board of Directors and management of XYZ Airline, Inc. and the appropriate airport authorities. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

[*Signature*]
[*Date*]

B. *Report on Internal Control Structure Used In Administering PFCs (Attestation Standards)*

Independent Auditor's Report

XYZ Airline, Inc.

We have examined management's assertion included in its representation letter, dated February 15, 19XX, that XYZ Airline, Inc. maintained an effective internal control structure over administering passenger facility charges collected, withheld, refunded/exchanged, and remitted during the year ended December 31, 19XX, for the purpose of complying with the regulations issued by the Federal Aviation Administration of the Department of Transportation to implement sections 9110 and 9111 of the Aviation Safety and Capacity Expansion Act of 1990.

Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of the internal control structure over financial reporting, testing and evaluating the design and operating effectiveness of the internal control structure, and such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

Because of inherent limitations in any internal control structure, errors and irregularities may occur and not be detected. Also, projections of any evaluation of the internal control structure over financial reporting to future periods are subject to the risk that the internal control structure may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assertion that XYZ Airline, Inc. maintained an effective internal control structure over administering passenger facility charges collected, withheld, refunded/exchanged, and remitted during the year ended December 31, 19XX, is fairly stated, in all material respects, based upon criteria established by the Committee of Sponsoring Organizations of the Treadway Commission.

This report is intended solely for the information and use of the Board of Directors and management of XYZ Airline, Inc. and the appropriate airport authorities. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

[*Signature*]
[*Date*]

Stage II Aircraft

.08 In September 1991, the FAA issued a final rule that requires airlines to eliminate all Stage II aircraft from their passenger fleets by the end of 1999. Stage II aircraft include Boeing 727s, 737-100s and 200s, and 747-100s; McDonnell Douglas DC-9s (except 80s) and certain DC-10s; BAC-111s; Fokker 28s; and any Boeing 707s or DC-8s that have been retrofitted to Stage II aircraft from Stage I aircraft. The final ruling provides airlines with two alternative phased compliance schedules and allows the airlines to select which schedule to adopt. Accordingly, airlines are required to do one of the following:

1. **Reduce** their base year pools (determined as of the end of 1990) of **Stage II** aircraft by 25 percent by the end of 1994, another 25 percent by the end of 1996, another 25 percent by the end of 1998, and the remaining 25 percent by the end of 1999

2. **Increase** their fleet percentage of **Stage III** airplanes to a minimum of 55 percent by the end of 1994, 65 percent by the end of 1996, 75 percent by the end of 1998, and 100 percent by the end of 1999

The alternative compliance schedules provide airlines with greater flexibility in complying with the FAA's requirement of phasing out all Stage II aircraft by December 31, 1999.

.09 Auditors of airlines should continue to consider whether accounting estimates of the remaining lives of Stage II aircraft in an airline's fleet are appropriate in light of the final regulation. Since virtually all airlines are affected by the final ruling, there is likely to be a further glut of Stage II aircraft on the market, resulting in declines in the market values of such aircraft. Auditors should also continue to consider whether previously estimated residual or salvage values used in calculating depreciation of such aircraft are appropriate.

Audit and Accounting Issues and Developments

Going-Concern Issues

.10 Several consecutive years of record losses, and possibly another in 1992, together with significant fare discounts, increased operating costs, and uncertain economic conditions, have seriously damaged the financial condition of many airlines. Auditors of airlines should carefully consider going-concern issues that may result from these and other factors. Going-concern problems are discussed in detail in *Audit Risk Alert—1992* [AAM section 8010].

.11 *COSO Report on Internal Control.* In September 1992, the Committee of Sponsoring Organizations (COSO) of the Treadway Commission issued its report *Internal Control—Integrated Framework.* The report defines internal control and its elements, provides tools for assessing internal controls, and addresses management reporting on internal controls over financial reporting.

.12 The full report consists of four volumes: "Executive Summary" provides a high-level overview; "Framework" defines internal control and describes its various components; "Reporting to External Parties" provides guidance to entities that report publicly on internal control over preparation of their published financial statements; and "Evaluation Tools" provides material to help in evaluating an internal control system.

.13 The four-volume set (No. 990002CL) costs $50; the "Executive Summary" (No. 990001CL) is available individually for $3. Prices do not include shipping and handling. To obtain either item, contact the AICPA Order Department.

Accounting for Aircraft

.14 *Aircraft Depreciation.* Concerns about economic obsolescence that were raised in prior years with regard to potential declines in the estimated useful lives and estimated residual values of aircraft continue to exist. In addition, the disposal of aircraft and nonrenewal of leases by airlines in bankruptcy have adversely affected the value of used aircraft, particularly Stage II aircraft, in the resale and leasing markets.

.15 The useful life of an aircraft and its residual value are often influenced by technological and economic as well as physical factors. Such factors include market growth, technological developments, operating cost efficiency, and revenue-generating ability. In recent years, other factors, such as the price and availability of fuel, new air-worthiness directives, new maintenance procedures, and required aircraft modifications, have also affected the useful lives of aircraft. High fuel prices tend to hasten the obsolescence of less fuel-efficient types of aircraft. Auditors should exercise judgment in evaluating the appropriateness of estimated useful lives and estimated residual values used in calculating depreciation of aircraft, keeping in mind factors that contribute to economic obsolescence, such as the strength of the secondary market, alternative uses, and the contemplated and long-term utilization currently assumed by the airline. Auditors may find the work of specialists such as valuation consultants to be useful in making such judgments.

.16 *Out-of-Service Aircraft.* High fuel prices and updated air-worthiness directives may cause airlines to decide that certain types of aircraft should be temporarily grounded. In such cases, auditors should consider the appropriateness of the balance-sheet classification of the aircraft as well as the adequacy of the related depreciation provision. If an aircraft is temporarily grounded but continues to be part of an airline's strategic fleet, depreciation should continue; however, the estimated useful lives and estimated residual values that are used should be carefully evaluated. When an airline has decided to remove an aircraft from service and offer it for sale, the aircraft should be classified as nonoperating property.

.17 *Aircraft Modifications.* Auditors should continue to carefully consider the appropriateness of aircraft modification costs that are capitalized rather than charged to expense. Factors that should be considered in making these determinations include the effect of the modification on the usefulness of the aircraft and on its service life as well as the cost of the modification. Guidance on making these determinations is provided in Statement of Position (SOP) 88-1, *Accounting for Developmental and Preoperating Costs, Purchases and Exchanges of Take-off and Landing Slots, and Airframe Modifications.*

Accounting for Engine and Airframe Overhaul Expense

.18 The AICPA Industry Audit Guide *Audits of Airlines* describes four acceptable methods of accounting for engine and airframe overhaul expense:

- Direct expensing method
- Built-in overhaul method
- Deferral method
- Accrual method

.19 The Securities and Exchange Commission staff has indicated that it would question an airline's change in accounting method relating to these costs, especially if the airline changed from a conservative method, such as the direct expensing method, to a more liberal approach, such as the deferred method.

Reporting on Advertising Costs

.20 On June 22, 1992, the AICPA issued an exposure draft of a proposed SOP, *Reporting on Advertising Costs.* The proposed SOP would amend paragraph 22 of SOP 88-1 and would require the following:

- Reporting the costs of all advertising as expenses in the periods in which those costs are incurred, or the first time the advertising takes place, unless the advertising is direct-response advertising that results in probable future economic benefits
- Reporting the costs of the future benefits of direct-response advertising as assets
- Amortizing the amounts reported as assets over the estimated period of the benefits

A final SOP is expected to be issued in 1993 and would be effective for financial statements for years beginning approximately one year after its issuance date.

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.21 This Audit Risk Alert supersedes *Airline Industry Developments—1991.*

* * * *

.22 Auditors should also be aware of the economic, regulatory, and professional developments that may affect the audits they perform, as described in *Audit Risk Alert—1992* [AAM section 8010].

[The next page is 8215.]

AAM Section 8100

Common Interest Realty Associations Industry Developments—1993

Industry and Economic Developments

.01 An uncertain economy continues to present difficult times and challenges to common interest realty associations (CIRAs). CIRAs generally derive the most significant portion of their revenues from assessments levied on members or unit owners. Over the past several years, many of those owners have seen the rate at which their units had been appreciating decline dramatically. Others have seen the market values of their units actually decrease. Such market factors, when combined with other financial concerns, have resulted in great reluctance on the part of many CIRA owners to accept assessment increases. Accordingly, CIRAs are finding it increasingly difficult to assess and collect the funds required to maintain and preserve their common property.

.02 The effects of financial strains being felt by individuals are not limited to resistance to special assessments and assessment increases. Increasing numbers of unit owners are finding themselves unable to pay their carrying charges on a timely basis, if at all, resulting in a negative effect on the cash flow of the CIRA.

.03 Some CIRAs rely on rental income from commercial units to supplement cash flow from unit owners. Many of those CIRAs are finding that the commercial real estate market continues to be sluggish and that rental income from those units is not meeting their expectations.

.04 Financial difficulties have also resulted in the inability of some unit owners to meet personal mortgage obligations. That, coupled with declining market prices for units and decreases in owners' equity because of overall declines in the real estate market, has resulted in abandonment of their units by some owners and an increase in foreclosures on units. As a result, an increasing number of units are owned by financial institutions. In addition, a growing number of sponsors have been unable to sell all their units, resulting in a greater percentage of units owned by sponsors, some of which may be economically unstable themselves. Increased ownership by financial institutions or sponsors may result in further declines in the market value of units, leading in some cases to abandonment of the units by the sponsors and financial institutions and the inability of the CIRA to continue as a going concern. Such concentrations of ownership may also raise internal control and related-party issues, as discussed in paragraphs .23-.24 and .27-.29. Some lending institutions cease lending to potential buyers when the number of units owned by a sponsor exceeds a specified level, making it even more difficult to sell the remaining units.

.05 Some CIRAs, primarily cooperatives, have underlying mortgages with balloon payments due on maturity. Those CIRAs are finding it increasingly difficult to obtain refinancing, raising questions about the CIRAs' ability to continue as going concerns.

.06 Many CIRAs in south Florida and Louisiana suffered extensive damage as a result of Hurricane Andrew in late summer 1992. Other CIRAs suffered extensive damage as a result of flooding in the Midwest in the summer of 1993. CIRAs that were insured have experienced delays in receiving payments under settlement of insurance claims, and some have experienced settlements that are significantly less than the damage suffered. Many of these CIRAs have been faced with the need to fund major repairs and replacements immediately. In some instances, the damage caused by these disasters, if not adequately covered by insurance, may raise substantial doubt about the ability of such CIRAs to continue as going concerns. Auditors of such CIRAs should consider management's plans for funding the necessary repairs and replacements. AICPA Statement on Auditing Standards (SAS) No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU section 341), provides guidance to auditors on evaluating whether there is substantial doubt about an entity's ability to continue as a going concern.

.07 Auditors also should consider how economic conditions in the areas in which the CIRAs they audit are located affect the risks inherent in the audit. Factors to be considered include regional unemployment rates (both actual and changed from the prior period), bankruptcy rates, foreclosure rates, and the usual percentage of sponsor-owned units. Indicators such as these require a general understanding of current economic conditions and the specific circumstances surrounding the CIRA being audited. Auditors should carefully consider whether the indicators create, intensify, or mitigate audit risk.

Regulatory and Legislative Developments

.08 SAS No. 22, *Planning and Supervision* (AU section 311), requires that, in planning their audits, auditors consider matters affecting the industry in which an entity operates, including, among other things, government regulations. Auditors consider such regulations in light of their potential impact on the financial statements being audited. SAS No. 54, *Illegal Acts by Clients* (AU section 317), distinguishes between two types of laws and regulations:

- Those that have a direct and material effect on the determination of financial statement amounts
- Those that relate more to an entity's operating aspects than to its financial and accounting aspects and therefore have only an indirect effect on the financial statements

Although auditors should design their audits to provide reasonable assurance of detecting material misstatements of the financial statements resulting from illegal acts that have a direct and material effect on the determination of financial statement amounts, an audit performed in accordance with generally accepted auditing standards does not include procedures specifically designed to detect illegal acts that would have only an indirect effect on the financial statements. Nonetheless, auditors should be aware of the possibility that such illegal acts may have occurred.

Federal Laws and Regulations

.09 CIRAs are not specifically regulated by the federal government. However, some federal laws deal with selling units in real estate developments, including certain CIRAs. Such laws include, for example—

- The Interstate Land Sales Full Disclosure Act, which requires developers or sponsors to register with the Office of Interstate Land Sales Registration before commencing interstate sales of property.
- The Securities Act of 1933, which applies if units are sold with an emphasis on the economic benefits to the purchaser (such as when units are offered with mandatory rental pool arrangements, if, according to the criteria established by the Securities and Exchange Commission, the sale is considered to be an offering of a security in the form of an investment contract).
- The Fair Housing Amendments Act of 1988, which prohibits discrimination in housing on the basis of disability or familial status, and applies to virtually all real estate sales and leases, including condominiums, homeowners' associations, and cooperatives. Under the law, unlawful discrimination is subject to fines.
- The Condominium and Cooperative Conversion Protection and Abuse Relief Act, which, among other things, offers unit owners limited protection from developer abuses that occur during conversion of rental units to condominiums or cooperatives and before the CIRA is transferred to the unit owners. The law provides, for example, for the termination of long-term contracts or leases with the developer that were entered into before conversion.

- The Americans with Disabilities Act, which gives certain civil protections to individuals with disabilities, and which includes sections on both employment and public accommodations that may affect CIRAs.

U.S. Department of Housing and Urban Development

.10 Through the Federal Housing Administration, the U.S. Department of Housing and Urban Development (HUD) regulates the development and operation of all projects, some of which include CIRAs, for which it insures mortgages or provides rent subsidies. CIRAs that receive financial assistance from HUD are required to submit audited financial statements to HUD annually. The audits of those financial statements are required to be performed in accordance with generally accepted auditing standards, *Government Auditing Standards,* issued by the Comptroller General of the United States and commonly referred to as the Yellow Book, and *Consolidated Audit Guide for Audits of HUD Programs,* issued by the HUD Office of the Inspector General (OIG).

.11 In July 1993, the HUD OIG issued a revised *Consolidated Audit Guide for Audits of HUD Programs,* which is effective for audits of financial statements for fiscal years ending September 30, 1993, and thereafter. The revised Guide provides program-specific audit requirements for entities that—

- Participate in HUD Section 8 Programs.
- Participate in insured and coinsured multifamily projects.
- Receive HUD-held mortgages, direct loans, capital advances, and other subsidies.
- Have insured development certifications.
- Issue Government National Mortgage Association mortgage-backed securities.
- Are HUD-approved Title II nonsupervised mortgagees and loan correspondents.
- Are HUD-approved Title I nonsupervised lenders and loan correspondents.

Significant changes in the revised Guide include the incorporation of final rules (dated December 9, 1992) for mortgage approval reform and direct-endorsement expansion and for implementing Office of Management and Budget Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions.* The revised Guide also deletes the "common" compliance requirements contained in the prior guide and provides revised suggested audit procedures for testing compliance with laws and regulations. Copies of the revised Guide (stock number 023-000-00805-0) can be obtained by writing to the Government Printing Office, Superintendent of Documents, Mail Stop SSOP, Washington, DC 20402-9328. The document can also be ordered by phone—(202) 783-3238—or fax—(202) 512-2250—and charged on Visa or MasterCard.

State Laws and Regulations

.12 Primary regulation of CIRAs is generally found at the state or local level of government. Most state laws and regulations are based on uniform state laws drafted by the National Conference of Commissioners of Uniform State Laws, which include—

- The Uniform Condominium Act.
- The Uniform Planned Community Act.
- The Model Real Estate Cooperative Act.
- The Uniform Common Interest Ownership Act, which applies to all types of common interest ownership developments.

These uniform state laws were drafted to encourage consistency among state statutes and also to attempt to address the conflicting interests of developers and sponsors, buyers, lenders, and others involved in CIRAs. Most states use the uniform laws as models for the development of their own statutes, modifying them to meet their individual needs. All states have enacted statutes to regulate certain aspects of the operations of CIRAs in their states. Auditors should be aware of common provisions that require a CIRA to—

- Have its financial statements audited, reviewed, or compiled by independent accountants, depending on the amount of the CIRA's annual revenues.
- Disclose certain additional information not required by generally accepted accounting principles, such as specific categories of revenues and expenses, along with its financial statements.
- Deliver annual financial statements to all unit owners within a specified period after the year end.

State and Local Taxation

.13 Significant state and local taxation issues for CIRAs remain unchanged from last year. Certain tax jurisdictions continue to be more aggressive in assessing the value of common property owned by CIRAs, particularly cooperative housing corporations, resulting in increased tax liabilities. Auditors should be aware of this and consider whether liabilities for taxes are properly recorded and, if the amounts of such assessments are being protested or are otherwise unresolved, whether contingencies for increased tax liabilities are properly accounted for and disclosed in conformity with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (AC C59).

Audit Issues

Information About Major Repairs and Replacements

.14 The AICPA Audit and Accounting Guide *Common Interest Realty Associations* (CIRA Guide) requires CIRAs to disclose certain unaudited supplementary information about future major repairs and replacements. Some CIRAs have elected not to comply with that requirement, and their auditors have therefore added explanatory paragraphs to the auditor's report referring to the omission of that information, in conformity with paragraph 7.39 of the CIRA Guide. Among the reasons some CIRAs have elected not to include that unaudited supplementary information is that they believe the cost of providing that information exceeds the benefits. Auditors may want to remind their clients that that information need not be obtained from professional engineers. Estimates made by the board of directors or obtained from licensed contractors may be satisfactory, as discussed in paragraphs 3.06 and 3.07 of the CIRA Guide.

Assessments and Collections

.15 In light of the industry and economic conditions discussed, past-due-assessment receivable balances of many CIRAs continue to increase. As a result, many CIRAs have entered into agreements with unit owners with past-due-assessment balances to establish or modify payment terms for past-due assessments. Auditors should consider whether increases in assessment-receivable balances are indicative of collectibility problems and should evaluate the ability of the CIRA to collect those balances. Generally, the existence of a formal or informal agreement is in itself not sufficient evidential matter to support the collectibility of the receivable.

.16 Historically, some CIRAs have expected that if unit owners failed to pay their assessments the CIRAs would be able to collect such assessments by filing liens against the units. However, CIRAs may not be able to enforce liens in some circumstances and, in other circumstances, amounts realized from liens may be insufficient to satisfy balances due. (Cooperatives generally have priority liens and stand a better chance of collecting unpaid assessments than do other CIRAs.) Often, either there is little or no equity remaining in units after settlement with tax authorities and secured creditors with priority liens, or the costs to collect exceed the charges assessed. In many foreclosure or collection cases, CIRAs have ended up with only a fraction of the lien amount, if any. Some states have passed legislation that gives priority to a portion of a CIRA's lien for assessments. In evaluating the collectibility of liens, auditors should consider the status of a CIRA's claims relative to other creditors.

.17 Other factors that may be relevant to the auditor's evaluation of the ability of a CIRA to collect liens include history of collection, intent and ability to enforce the lien, and the underlying value of the units.

Reserve Funds

.18 One of a CIRA's primary duties is to maintain and preserve its common property. CIRAs may fund the cost of such maintenance and preservation by assessing owners as funds are needed or by budgeting for the anticipated costs over an extended period and collecting assessments from owners regularly over those periods. Amounts collected are generally recorded as reserve funds until they are needed. Some CIRAs are required by state statutes, by their own governing documents or regulatory requirements, or by debt covenants to maintain minimum balances in reserve funds.

.19 Generally, continued decline in interest rates has resulted in lower returns on amounts held for investment in reserve funds. Additionally, the recession has made unit owners more sensitive to increased carrying charges, resulting in a tendency by some CIRAs to forego some assessments for future repairs and replacements.

.20 As a result, some CIRAs, such as those that have suffered extensive damage as a result of recent natural disasters, may be underfunded for future repairs and replacements and may be in violation of their own funding policies or debt covenants, or in violation of the state statutes that set forth funding requirements. Some CIRAs may also be violating their governing documents or state statutes by using reserve funds to finance current operations.

.21 A CIRA's compliance with governing documents or state statutes concerning funding for future repairs and replacements and the status of such funding are required financial statement disclosures for CIRAs. Auditors should consider the factors in the previous two paragraphs when evaluating the adequacy of the CIRA's financial statement disclosures about funding for future major repairs and replacements, as well as disclosures about violations of debt covenants. Furthermore, noncompliance with state statutes may be an illegal act, as described in SAS No. 54 (AU section 317). Auditors should refer to SAS No. 54 (AU section 317) for auditing guidance concerning illegal acts.

Going Concern Issues

.22 Decreased cash flows resulting from uncollected carrying charges, generally lower investment returns, extensive damage from natural disasters, and lost rental income from commercial units, as well as underfunding for future repairs and replacements, ownership of units by sponsors and financial institutions, and the inability to obtain financing may continue to raise substantial doubt about a CIRA's ability to continue as a going concern. Auditors should consider these factors in applying SAS No. 59 (AU section 341) and should evaluate whether these factors indicate there is a substantial doubt about the CIRA's ability to continue as a going concern. Understanding and evaluating these factors requires a general understanding of the entity's business and the current economic conditions in which the entity is operating.

Transactions With Related Parties

.23 FASB Statement No. 57, *Related Party Disclosures* (AC R36), establishes requirements for the disclosure of related-party transactions. In the CIRA environment, sponsors and financial institutions sometimes meet the definition of related parties set forth in FASB Statement No. 57 (AC R36). Auditors should consider whether increases in ownership by sponsors and financial institutions precipitate relationships that establish related parties as defined in FASB Statement No. 57 (AC R36).

.24 SAS No. 45, *Omnibus Statement on Auditing Standards—1983* (AU section 334), provides guidance on procedures that auditors should consider to identify related-party relationships and transactions and to satisfy themselves about the required accounting for and disclosure of such transactions.

Significant Sources of Revenue

.25 If 10 percent or more of a CIRA's revenues are derived from any one source, paragraph 4.24 of the Guide requires that fact and the amount of revenue from each source to be disclosed. Auditors should consider whether increases in ownership by sponsors and financial institutions precipitate circumstances that require that disclosure.

Loss of Tax-Exempt Status

.26 In some cases, sponsor defaults have led to CIRAs taking ownership of shares previously owned by sponsors. In many cases, those CIRAs derive rental income from those units. Section 216 of the Internal Revenue Code states that no more than 20 percent of a cooperative's total gross income can be derived from other than tenant-shareholders. Auditors should consider whether increases in rental income have resulted in potential loss of tax-exempt status and whether financial statement disclosures concerning that are adequate.

Internal Control Structure Considerations

.27 Continued increased ownership by sponsors and financial institutions, increased awareness of litigation and the potential for personal liability, and personal job pressures continue to result in a decrease in some CIRAs' ability to find qualified officers, directors, and other volunteers willing to serve the CIRA.

.28 Additionally, the portion of CIRAs managed by small, and frequently inexperienced, management companies continues to increase. Also, some smaller CIRAs continue to elect self-management as a cost-saving measure.

.29 Therefore, some CIRAs are managed by individuals who may be unqualified or who may not make the necessary time commitment, or both. SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AU section 319), requires auditors to obtain an understanding of an entity's internal control structure. Auditors should consider the impact these factors may have on their consideration of the CIRA's internal control structure, particularly the control environment.

Compilation and Review Developments

.30 The CIRA Guide requires CIRAs to disclose certain supplementary information outside of the basic financial statements. This requirement also applies to CIRAs whose financial statements are compiled or reviewed in accordance with Statements on Standards for Accounting and Review Services (SSARSs). Paragraph 43 of SSARS 1, *Compilation and Review of Financial Statements* (AR section 100.43), describes the accountant's responsibility when the financial statements are accompanied by information voluntarily presented for supplementary analysis purposes; however, SSARSs do not address the accountant's responsibility when the financial statements are accompanied by required supplementary information. AICPA Statement of Position (SOP) 93-5, *Reporting on Required Supplementary Information Accompanying Compiled or Reviewed Financial Statements of Common Interest Realty Associations,* amends chapter 8 of the CIRA Guide by providing accountants with performance and reporting requirements when required supplementary information accompanies the basic financial statements in a compilation or review engagement. The SOP is effective for compilations and reviews of financial statements for periods ending on or after December 15, 1993. The SOP—

- Requires that accountants, at a minimum, compile the required supplementary information accompanying compiled or reviewed financial statements.
- Specifies the procedures that should be performed when compiling the required supplementary information.

- Specifies the elements to be included in a report on required supplementary information accompanying compiled or reviewed financial information.

Other Sources of Information

.31 Organizations such as the following may be able to provide auditors with additional information about CIRAs.

Community Associations Institute
1630 Duke St
Alexandria, VA 22314
(703) 548-8600

National Association of Housing Cooperatives
1614 King St
Alexandria, VA 22314
(703) 549-5201

* * * *

.32 This Audit Risk Alert replaces *Common Interest Realty Associations Industry Developments—1992.*

* * * *

.33 Practitioners should also be aware of the economic, regulatory, and professional developments in *Audit Risk Alert—1993* [AAM section 8010] and *Compilation and Review Alert—1993* [AAM section 8015].

[The next page is 8233.]

AAM Section 8110
Casino Industry Developments—1992

Industry and Economic Developments

.01 The casino industry has proved to be resilient, even in the current economic climate. The results vary greatly from casino to casino, though virtually all seem to have improved compared to 1991. The Atlantic City casino industry is making a slow recovery from several years of low profits. In May 1992, the state legislature approved further changes to promote gaming revenues in Atlantic City. Under the package, which was signed by Governor Florio, the Casino Control Commission (CCC) can permit 24-hour gaming virtually year-round and can also sanction table games, such as poker and keno, without legislative approval. In 1992, the CCC eased the requirement limiting the amount of floor space devoted to slot machines, allowing more profitable "one-armed-bandits" in place of less profitable table games. Southern Nevada has absorbed the new capacity that was added in 1989 and 1990 and now expects that current construction will be completed in 1993. It seems that not even a weak economy and increased out-of-state competition can stop Las Vegas from adding casinos. Currently, some $2 billion is being spent on new casino projects, expansions, and renovations due to open over the next 18 months.

.02 Other states have promoted games of chance since New Jersey made Atlantic City the main rival to Las Vegas in 1978. Gambling riverboats now ply waterways throughout the nation's heartland, and scores of Indian tribes have begun running gambling halls on their lands. State lotteries are seeking to expand by offering video-lottery terminals, similar to casino-style video games. New Orleans has already voted to allow casino gambling as a new source of tax revenue, and Chicago is considering doing the same. The trend should prove to be favorable to companies that sell gaming equipment. It may also prove to be advantageous to casinos with the expertise and financial ability to expand into these new markets.

Regulatory Developments

.03 Some states have recently passed regulations that allow the states to select auditors of casinos in their jurisdiction. This may affect auditors of casinos who are parent companies of casinos (or who have divisions, branches, or components) in states that appoint auditors for casinos in their jurisdiction. Auditors of these (parent) casinos must use judgment in deciding (1) whether they may serve as principal auditor and use the work of appointed auditors who have audited the financial statements of one or more subsidiaries, divisions, branches, or components included in the financial statements presented, and (2) the form and content of the principal auditor's report in these circumstances. Auditors in this situation should follow the guidance in Statement on Auditing Standards (SAS) No. 1, section 543, *Part of Audit Performed by Other Independent Auditors* (AU section 543).

Bank Secrecy Act

.04 Casinos should be mindful that the Bank Secrecy Act, which includes stringent reporting and record-keeping requirements, applies to them. Failure to comply with the provisions of the act may result in the assessment of severe penalties against casinos. The act was instituted to discourage the use of currency in illegal transactions and to identify unusual or questionable transactions that could aid in criminal, tax, and other regulatory investigations. The government is vigorously enforcing the act, and casinos need to closely review their compliance with its reporting and record-keeping requirements. Auditors facing questions pertaining to the Bank Secrecy Act should follow the guidance in SAS No. 54, *Illegal Acts by Clients* (AU section 317).

Audit Issues and Developments

Going-Concern Issues

.05 Due to the current sluggish economy, increased competition, and heavy debt burdens, some casinos may be unable to meet their obligations as they become due and are considering such options as substantial disposition of assets, restructuring of debt, and even dissolution. The new projects in Las Vegas are likely to put even greater pressures on the city's older, less glamorous casinos. In the past three years, at least a dozen Las Vegas casinos have closed or entered bankruptcy proceedings. Many casino executives expect this trend to continue. Such conditions should prompt auditors to carefully consider the provisions of SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU section 341). SAS No. 59 (AU section 341) requires auditors to evaluate, based on the results of audit procedures performed, whether there is substantial doubt about an entity's ability to continue as a going concern.

.06 Specifically, auditors of casinos should consider items such as—

- The ability of casinos that have borrowed heavily in the past to meet debt-service obligations.
- Management's plans to dispose of assets to address overcapacity or to generate funds needed for operating purposes.
- The ability of casinos to generate the player traffic necessary to support the capacity generated by the industry.
- The dilution of competent or experienced management resulting from the spread of legalized gambling.

Going concern problems are discussed in detail in *Audit Risk Alert—1992* [AAM section 8010].

The Confirmation Process

.07 Confirmation of balances is generally an important procedure in auditing the financial statements of casinos. In November 1991, the AICPA's Auditing Standards Board (ASB) issued SAS No. 67, *The Confirmation Process* (AU section 330), which provides guidance on the confirmation process in audits performed in accordance with generally accepted auditing standards. It defines the confirmation process, discusses the relationship of confirmation procedures to the auditor's assessment of audit risk, describes certain factors that affect the reliability of confirmations, and provides guidance on performing alternative procedures when responses are not received and on evaluating results of confirmation procedures. SAS No. 67 (AU section 330) specifically addresses the confirmation of accounts receivable and explicitly prohibits the use of negative confirmation requests when control risk is assessed at the maximum level. SAS No. 67 (AU section 330) is effective for audits of fiscal periods ending after June 15, 1992. *Audit Risk Alert—1992* includes further discussion of SAS No. 67 (AU section 330).

Internal Control

.08 The internal control structure over the financial reporting of casinos is generally a critical audit consideration. The casino industry operates in a cash environment characterized by a large number of transactions. Gaming operations are subject to a greater than normal risk of loss caused by employee or customer dishonesty because (1) it is not practical to record all individual table game transactions, (2) cash receipts or equivalents are not recorded until they are removed from the drop boxes and counted, and (3) the revenues produced are not from the sale of products or services that are readily measurable. For that reason, auditors should pay particular attention to the control environment of casinos and to the design of their auditing procedures (especially tests of controls). Particular emphasis may be placed on observation tests of a casino's operations.

.09 The ASB has exposed for comment a proposed Statement on Standards for Attestation Engagements (SSAE), *Reporting on an Entity's Internal Control Structure Over Financial Reporting*. This statement, which would supersede SAS No. 30, *Reporting on Internal Accounting Control* (AU section 642), addresses engagements in which a CPA examines and reports on management's written assertion about the effectiveness of an entity's internal control structure for financial reporting. A final statement is expected to be issued in the first quarter of 1993.

Computer Processing

.10 Many casinos have implemented complex computer systems to process their significant accounting information. Auditors of casinos with such computer processing systems should follow the guidance of SAS No. 48, *The Effects of Computer Processing on the Audit of Financial Statements,* which amends SAS No. 22, *Planning and Supervision* (AU section 311).

COSO Report on Internal Control

.11 In September 1992, the Committee of Sponsoring Organizations (COSO) of the Treadway Commission issued its report *Internal Control—Integrated Framework.* The report defines internal control and its elements, provides tools for assessing internal controls, and addresses management's reporting on internal controls over financial reporting.

.12 The full report consists of four volumes: "Executive Summary" provides a high-level overview; "Framework" defines internal control and describes its various components; "Reporting to External Parties" provides guidance to entities that report publicly on internal control over preparation of their published financial statements; and "Evaluation Tools" provides material to help in evaluating an internal control system.

.13 The four-volume set (No. 990002CL) costs $50; the "Executive Summary" (No. 990001CL) is available individually for $3. Prices do not include shipping and handling. To obtain either item, contact the AICPA Order Department.

Competence of Management

.14 SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AU section 319), states that, in all audits, the auditor should obtain a sufficient understanding of an entity's internal control structure: the control environment, the accounting system, and control procedures. The control environment reflects the overall attitude, awareness, and actions of the board of directors, management, owners, and others concerning the importance of control and its emphasis in the entity. Auditors of casinos should be alert to the fact that management's competence with respect to the recent expansions in the industry and innovative types of gaming should be closely considered in their assessment of control risk.

Accounting Developments

Accounting for Slot Clubs

.15 Casinos have been engaging in a new promotional activity known as "slot clubs." These are clubs where members are given "credit cards" by the casinos for use in the slot machines. For every coin put in a slot machine, a credit is put on the card. The card may then be used by the club member to receive items such as money, prizes, discounts, etc. Auditors should consider inquiring of a casino's management as to whether this or a similar type of arrangement exists. If so, auditors should consider whether appropriate internal controls exist over the arrangement and that management is appropriately accruing for and disclosing liabilities incurred.

Promotional Allowances

.16 Most casinos offer promotional allowances to patrons to induce them to visit and to gamble. Such allowances generally consist of complimentary or discounted rooms, food and beverages, entertainment, and parking. Allowances of this nature become more common as competition in the casino industry increases.

.17 Generally accepted accounting principles require that the cost of promotional allowances be included in costs and expenses. The retail value of promotional allowances may be disclosed either in the notes to the financial statements or by including the amount in gross revenues and offsetting the amount by a deduction on the face of the income statement.

.18 Some casinos may be inclined to defer certain expenses related to promotional allowances. There is no authoritative literature to support deferring such costs to future periods. The costs of promotional allowances should be charged to expense in the period in which they are incurred.

Discounting Casino Reinvestment Development Authority Bonds (New Jersey)

.19 The Casino Reinvestment Development Authority (CRDA) in New Jersey requires casinos operating in Atlantic City to purchase CRDA bonds, the proceeds of which are used to redevelop the Atlantic City area. The interest rate on these bonds may be below the prevailing rate of interest. In accounting for such bonds, casinos should consider Accounting Principles Board Opinion No. 21, *Interest on Receivables and Payables* (AC I69). The rate used for valuation purposes should normally be at least equal to the rate at which the casino can invest in similar instruments from other sources at the date of the transaction. The difference between the present value and the face amount should be treated as a discount and amortized as interest income over the life of the bond in such a way as to result in a constant rate of interest when applied to the amount outstanding at the beginning of any given period. Auditors should consider whether rates used to discount casinos' CRDA bond holdings are appropriate. Use of stated rates rather than market rates could result in a misstatement of interest income, discount amount, and bond-carrying value.

Troubled-Debt Restructurings

.20 Casinos in financial difficulty may face pressure to restructure some or all of their debt. Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings* (AC D22), as amended and interpreted, presents the standards of financial accounting and reporting by debtors (and creditors) for a troubled-debt restructuring. Debt restructuring may take the form of either a transfer of assets (or equity interest) from a debtor to a creditor in full settlement of a debt or a modification of terms. When casinos engage in either of these two types of restructurings, auditors should consider whether the financial statements properly reflect the results of the restructuring and include appropriate disclosures.

Concentrations of Credit Risk

.21 The provisions of FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (AC F25), extend to the potential loss of cash funds in excess of $100,000 (the Federal Deposit Insurance Corporation [FDIC] insurance coverage). If a casino exceeds this limit, the contingency may need to be disclosed in the footnotes to the financial statements. FASB Statement No. 105 (AC F25) may also require the disclosure of other items, such as the amounts of contractual obligations; other significant concentrations of credit risk, such as large receivables from one customer or concentrations of business in certain geographic regions; and descriptions of customer financing arrangements.

Income Taxes

.22 In February 1992, the FASB issued Statement No. 109, *Accounting for Income Taxes* (AC I73). The Statement establishes financial accounting and reporting standards for the effects of income taxes that result from an enterprise's activities during the current and preceding years. It requires an asset and liability approach for financial accounting and reporting for income taxes. The Statement supersedes FASB Statement No. 96, *Accounting for Income Taxes,* and amends or supersedes other accounting pronouncements (see appendix D of FASB

Statement No. 109). The Statement is effective for fiscal years beginning after December 15, 1992, with earlier application encouraged.

.23 Casinos should be cautious about recording deferred tax assets. Auditors of casinos should be familiar with the criteria for recognition of a deferred tax asset, as well as with the guidance for establishing an appropriate valuation allowance.

Unreported Employee Tips

.24 There have been recent investigations by the Internal Revenue Service relating to unreported tips by employees. These investigations may result in additional FICA taxes for employing casinos, plus potential interest and penalties, for some entities. Management should evaluate their individual situation and, if necessary, make an accrual for any probable and reasonably estimatable contingency in accordance with FASB Statement No. 5, *Accounting for Contingencies* (AC C59).

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.25 This Audit Risk Alert supersedes *Casino Industry Developments—1991.*

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.26 Auditors should also be aware of the economic, regulatory, and professional developments that may affect the audits they perform, as described in *Audit Risk Alert—1992* [AAM section 8010].

[The next page is 8247.]

AAM Section 8120

Construction Contractors Industry Developments—1993

Industry and Economic Developments

.01 As expected, 1993 continues to provide both challenges and opportunities for the construction industry in the United States. Tougher competition, longer bid lists, and thinner profit margins, on the one hand, are offset by increases in select bid participation and some pure negotiated work, on the other. Increasing workers' compensation obligations, demand for better safety and loss control programs, restricted surety capacity, improper contractual risk transfers, environmental liabilities, and insurance coverage gaps are among the many important risk issues facing the industry.

.02 Low interest rates are continuing to support the housing market, although consumer confidence is still wavering. The single-family component remains strong, with building activity in the southern states leading the way. Mortgage interest rates recently touched a twenty-year low. This trend, along with more reasonable home prices, has returned affordability to the market after the tremendous rise in property values throughout the 1980s. Although it is possible that interest rates are near their lows for this cycle, it is expected that favorable rates will remain available to consumers over the next few years, permitting house-building activities to increase.

.03 The country's unemployment situation has improved only slightly, and if this condition persists, the housing market could feel the effects of a scarcity of eligible consumers. Housing starts in the South and Southwest continue to post year-to-year gains. During 1992, housing starts increased 20 percent in the South and 25 percent in the Southwest. Both regions were above the national average increase of 19.4 percent. The Southwest has one of the lowest home ownership rates in the nation. This, coupled with the region's sharp increase in personal income (approximately 5 percent) and steady employment growth, should keep the demand for new housing strong through 1994. The Midwest has seen a decline in housing starts of approximately 9 percent during the first half of 1993, compared to the same period in 1992. Heavy rains have kept the ground too wet for foundations to be laid. This is expected to be a short-term problem, though, because the flood damage will need to be repaired.

.04 Overbuilding during the 1980s has led to high vacancy rates in office buildings, hotels, and other commercial buildings across the nation. Experts estimate that the commercial real estate slump will persist well into the middle of the decade. The current downturn has been sharpened by the record collapse of hundreds of financial institutions in the past few years. The failure of many of the most aggressive lending institutions and tighter regulation of the remaining institutions have led to credit restrictions for the real estate industry. Tighter credit has led to falling asset prices, which makes it more difficult to justify new commercial construction.

Overall and Specific Risks

.05 Due to the unique nature of a construction contractor's business and the extensive use of estimates, audits of construction contractors can be relatively complex. Estimates relating to future events affect the determination of contract costs, revenues, gross profits, and percentage of completion.

.06 An assessment of the degree of overall audit risk involved in a construction contractor's financial statements can be made by reviewing total gross profit from contracts in progress. As the percentage of gross profit subject to the estimating process increases (that is, the percentage of contracts in progress as opposed to completed contracts increases), there is a greater reliance on estimates and a corresponding increase in audit risk since the construction contractor's working capital, equity, and income will be based largely on these estimates.

.07 The following specific conditions generally indicate increased audit risk:

- Lack of controls or weak controls over bidding and estimating projects
- Inadequate review procedures over the drafting of customized construction contract documents
- Increased frequency of losses on contracts
- Apparent incompetence, lack of skill, or inadequate training of field personnel bidding on contracts, estimating contracts' progress, and estimating costs to complete contracts
- Recognition of declining gross profit rates on contracts in progress, instead of on completed contracts during the period
- Variability in gross profit rates realized on completed contracts
- Deteriorating gross profit rates toward the end of the accounting period
- Inadequate monitoring of projects in progress
- Increase in underbillings on contracts
- Inadequate oversight of subcontractors' operations
- Decrease in cash flows
- Increase in bank borrowings
- Notes or accounts receivable from related parties
- Participation in unaudited joint ventures
- Unsophisticated financial information techniques for preparation of financial statements to be reviewed by sureties for bonding
- Inadequate monitoring of the progress of pending litigation

Audit Issues and Developments

Estimated Costs to Complete

.08 The construction industry continues to face reduced activity and a resultant reduced profit margin on bid work. This reduced level of activity may continue for the next few years. Given this environment of reduced profit margins, auditors should carefully review the contractor's estimated costs to complete to determine whether losses may be incurred on the contract. As indicated in the AICPA Audit and Accounting Guide *Construction Contractors*, one of the most important phases of the audit of a construction contractor relates to estimated costs to complete contracts in process, since that information is used in determining the estimated final gross profit or loss on contracts. Estimated costs to complete involve expectations about future performance, and the auditor should—

- Critically review representations of management.
- Obtain explanations of apparent disparities between estimates and past performance on contracts, experience on other contracts, and information gained in other phases of the audit.
- Document the results of work in these areas.

Because of the direct effect on the estimated interim and final gross profit or loss on the contract, the auditor should evaluate whether the contractor's estimate of cost to complete is reasonable. AICPA Statement on Auditing Standards (SAS) No. 57, *Auditing Accounting Estimates* (AU section 342), provides guidance to auditors on obtaining and evaluating sufficient competent evidential matter to support significant accounting estimates in an audit of financial statements in accordance with generally accepted auditing standards.

Job Site Visits

.09 In certain situations, visits to selected job sites are essential for the auditor to understand the construction contractor's operations and to relate the internal accounting information to events that occur at the job sites. In addition, such visits can provide invaluable first-hand information about the physical status of projects and operational problems. Job site visits are required when the auditor intends to assess control risk at the site as low or when the related accounts cannot be substantiated by other procedures. Although the level of accounting functions (and related control procedures) varies depending on the size of the project, one objective of a site visit is obtaining information and supporting documentation to evaluate the reasonableness of the progress of the project to date. The auditor may perform such procedures as—

- Identifying uninstalled materials that should be excluded when measuring progress toward completion, and noting physical security over such materials.
- Discussions with job site personnel as to the status of labor hours incurred to date and estimates to complete, including evaluating those estimates by observing the physical progress of the project. If the project is complex, the auditor should consider engaging the services of a specialist [see guidance in SAS No. 11, *Using the Work of a Specialist* (AU section 336)].
- Observing contractor-owned or rented material.
- Discussing with job site personnel issues that may affect the estimated total gross margin (such as problems encountered or operational inefficiencies).

Going-Concern Issues

.10 The economy has had a significant effect on the construction contracting industry and there have been high failure rates among contractors in recent years. Auditors of construction contractors should be alert to conditions that may indicate the existence of substantial doubt about the contractor's ability to continue as a going concern. Going concern problems are discussed in detail in *Audit Risk Alert—1993* [AAM section 8010]. Some construction contractors may be emerging from bankruptcy, in which case, the auditor should consider whether the contractor is following the guidance of AICPA Statement of Position 90-7, *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code.*

Environmental Issues

.11 The Environmental Protection Agency is empowered by law to seek recovery from any party that ever owned or operated a contaminated site, or anyone who ever generated or transported hazardous materials to a site. In view of the liabilities that may result from owning contaminated sites, virtually all real estate transactions entered into today give consideration to environmental liabilities. Auditors of construction contractors that face such claims should carefully consider whether the accounting and disclosure requirements of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (AC C59), have been met. They should be cognizant of the consensus reached by the FASB's Emerging Issues Task Force (EITF) in Issue No. 93-5, *Accounting for Environmental Liabilities,* that, among other things, an environmental liability should be evaluated independently from any potential recovery and that the loss arising from the recognition of an environmental liability should be reduced only when a claim for recovery is probable of realization.

.12 Auditors of public construction contractors should be aware of the Securities and Exchange Commission's (SEC's) Staff Accounting Bulletin (SAB) No. 92, *Accounting and Disclosures Relating to Loss Contingencies,* which addresses issues related to loss contingencies, focusing primarily on environmental and product liability contingencies. The SAB provides the SEC staff's interpretation of current accounting literature related to the following:

- Offsetting probable recoveries against probable contingent liabilities
- Recognition of liability for costs apportioned to other potential responsible parties
- Uncertainties in estimation of the extent of environmental or product liability
- The appropriate discount rate for environmental or product liabilities, if discounting is appropriate
- Accounting for exit costs
- Financial statement disclosures and disclosure of certain information outside the basic financial statements

Significant Real Estate Holdings

.13 Some construction contractors may have significant real estate holdings. Because of the weak real estate market, certain current values are significantly lower than those even as recently as six months to a year ago. One of the factors contributing to the rapid decline in values is the emergence of substantial real estate portfolios available for sale. Even recent independent appraisals may have failed to fully reflect current market conditions as the appraisal may be based, in part, on specific assumptions stipulated by the company ordering the appraisal. Real estate, although traditionally considered a long-term investment, is currently even less liquid than in prior years, because of excess supply and limited credit availability.

.14 The following are some conditions which may indicate a need for auditors to further consider the appropriateness of real estate valuations and related disclosures:

- Cash flows from operating activities are insufficient to cover debt service.
- Current occupancy rates indicate that the future cash flows to be received from the investment are lower than the amounts needed to fully recover the investment's carrying amount.
- Properties held for sale remain unsold at subsequent balance-sheet dates.
- The number of delinquent loans or repossessed properties has increased.
- The value of the real estate that collateralized nonrecourse mortgage loans has declined.
- Other investors have decided to cease providing support or to reduce their financial commitment to the real estate project or venture.
- The previous year's auditor's report contains an explanatory or emphasis paragraph relating to real estate investments.

When circumstances such as these are present, auditors should consider the need for appropriate write-downs or reserves and the impact on any disclosures required by FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* (AC F25), or voluntary fair-value disclosures. Interpretation No. 1, "Performance and Reporting Guidance Related to Fair Value Disclosures," of SAS No. 57 (AU section 9342) was issued in February 1993 to provide auditors performance and reporting guidance related to fair-value disclosures.

Economic Conditions

.15 In periods of economic distress, contractors may assume greater risks, one being the use of a low bid from a subcontractor who could not obtain a bond. In these cases, the contractor is taking the risk that the subcontractor may not be financially stable, which may affect the subcontractor's ability to complete the contract. Auditors should monitor these situations closely and obtain reasonable assurance that management has properly identified, accrued for, and disclosed any such matters in accordance with FASB Statement No. 5 (AC C59).

Accounting Issues and Developments

Joint Ventures—Accounting by the Investor

.16 By combining resources with one or more other contractors, a contractor may be able to bid and complete larger, more complex construction projects. Contractors may also move into geographic areas by forming joint ventures (JVs) with contractors in those areas. Some JVs are designed and created for bidding, negotiating, and performing one specific project. Other JVs are created to be permanent. The purpose of permanent JVs is generally to pool resources and to bid on all contracts of a specific type for an indefinite period of time.

.17 *Evaluation of Control.* In evaluating whether a JV needs to be consolidated, an agreement between the venturers that requires the consent of both venture parties for typical corporate actions generally indicates neither venturer has control. For example, if a majority holder cannot order the sale of assets in the ordinary course of business without the consent of its JV partner, the majority owner generally does not have control. However, if the JV agreement requires the consent of both parties only in the case of a disposition of *substantially all* assets, an action that is clearly not in the ordinary course of business, the SEC staff has informally concluded that this provision would not negate other aspects of control. The following are some examples of evaluating the control situation:

- In one situation, the majority owner did not have the unilateral ability to buy, sell, or pledge assets without the consent of its JV partner if the transaction exceeded 5 percent of the JV asset base. In this case, control was not present.

- In another situation, a 50 percent owner (1) had the tie-breaking vote with respect to operating and financial policies of the JV, (2) had the ability to acquire and dispose of assets in the ordinary course of business, and (3) could dispose of up to 95 percent of JV assets without the consent of the JV partner. In this case, the 50 percent owner had control.

.18 *Contributions of Assets.* As a general rule, the contributions of assets to a JV should not result in gain recognition. However, when cash is received by the investor without any commitment for reinvestment, gain recognition may be considered acceptable. Under EITF Issue No. 89-7, *Exchange of Assets or Interest in a Subsidiary for a Noncontrolling Equity Interest in a New Entity,* such gain should not be recognized if the enterprise has an actual or implied commitment, financial or otherwise, to support the operations of the new entity. The SEC has emphasized that any gain recognition is heavily dependent on a careful analysis of specific facts and circumstances. Gain recognition would not be appropriate if a significant uncertainty exists regarding realization or the enterprise has an actual or implied commitment to support the operations of the new entity in any manner. Gains may also be recognized to the extent that other *near cash,* such as monetary assets or traded marketable securities, are part of the exchange.

Accounting for Income Taxes

.19 In February 1992, the FASB issued Statement No. 109, *Accounting for Income Taxes* (AC I27), which becomes effective this year. FASB Statement No. 109 (AC I27) requires an asset and liability approach for financial accounting and reporting for income taxes. It requires recognition of (1) current tax liabilities or assets for the estimated taxes payable or refundable on tax returns for the current year, and (2) deferred tax liabilities or assets for the estimated future tax effects attributable to temporary differences and tax operating loss and credit carryforwards. Some of the common types of temporary differences that may occur in the construction industry are—

- Differences in computing percentage of completion. These may arise even when a construction contractor uses the percentage of completion method for both generally accepted accounting principles and tax.
- Differences between the percentage of completion method and other methods used for tax purposes.
- Differences due to losses accrued on percentage of completion contracts with future losses identified.
- Differences in depreciation methods.
- Differences in accounting for investments in joint ventures, partnerships, and other entities.

Auditors of construction contractors should refer to *Audit Risk Alert—1993* [AAM section 8010] for a more detailed discussion of auditing, accounting, and implementation issues relating to FASB Statement No. 109 (AC I27).

Disclosures—Publicly Held Companies

.20 *Management's Discussion and Analysis.* SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AU section 550), requires that auditors read such information and consider whether it and the manner of its presentation are materially consistent with information appearing in the financial statements. As auditors of construction contractors that are required to file reports with the SEC read the Management's Discussion and Analysis of Operations (MD&A) sections of SEC filings, they might consider whether the MD&A includes discussions of—

- The impact of recently issued accounting standards which are not effective until some future date. If the adoption of a standard is expected to have a significant effect on the insurance company's financial position or results of operations, the MD&A disclosure should (1) notify that a standard has been issued which the construction contractor will be required to adopt in the future, and (2) assess the significance of the impact that the adoption of the standard should have on the company's financial statements (unless this cannot be reasonably estimated, in which case, a statement to that effect should be made).
- Known trends, demands, commitments, events, or uncertainties that are reasonably likely to have a material effect on the construction contractor's results of operations or financial condition.

AICPA Audit and Accounting Literature

Audit and Accounting Guide

.21 The AICPA Audit and Accounting Guide *Construction Contractors* is available through the AICPA's loose-leaf subscription services. In the loose-leaf service, conforming changes (those necessitated by the issuance of new authoritative pronouncements) and other minor changes that do not require due process are incorporated periodically. Paperback editions of the guides as they appear in the service are printed annually.

Construction Contractors' Financial Reporting Checklists

.22 The AICPA's Technical Information Service has published a revised version of *Checklists Supplement and Illustrative Financial Statements for Construction Contractors* as a tool for preparers and reviewers of financial statements of construction contractors.

Technical Practice Aids Publication

.23 *Technical Practice Aids* is an AICPA publication that, among other things, contains questions received by the AICPA's Technical Information Service on various subjects and the service's responses to those questions. Several sections of *Technical Practice Aids* contain questions and answers specifically pertaining to construction contractors. *Technical Practice Aids* is available both as a subscription service and in hardback form.

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.24 This Audit Risk Alert replaces *Construction Contractors Industry Developments—1992.*

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.25 Practitioners should also be aware of the economic, regulatory, and professional developments in *Audit Risk Alert—1993* [AAM section 8010] and *Compilation and Review Alert—1993* [AAM section 8015].

[The next page is 8263.]

AAM Section 8130

Federal Government Contractors Industry Developments—1993

Industry and Economic Developments

.01 In the face of federal government spending cutbacks, government contractors continue to respond to a declining number and amount of government contract awards by restructuring their business base or choosing not to continue to compete for government contracts. Many defense contractors are pursuing strategies for alternative uses of technology in the commercial marketplace. Some contractors may be experiencing increased operating costs as a result of charging idle personnel to overhead for extended periods. Many companies have significantly reduced their work force but find that additional cost-cutting measures are necessary to remain competitive. Some contractors have responded to government cutbacks and highly competitive foreign companies in the same market by consolidating their core lines of business, or by acquiring related divisions from other contractors and disposing of noncore business lines. Such restructurings allow contractors to eliminate overlapping engineering and support staff, while creating synergies by broadening their technological base and increasing market base.

.02 The decline of available procurement contracts has fueled an increase in the number of appeals and protests. In the first half of 1993, over 300 cases were filed with the General Services Board of Contract Appeals, most of which were appeals relating to procurements of computer and telecommunications equipment and services by all federal agencies.

.03 Because of government-customer budget constraints, many contractors continue to experience increases in claim activity related to the cancellation of contracts. The claims may result from (1) contract performance problems and concerns, (2) letter contracts or other expedited procurement processes initiated by the government, or (3) government-initiated contract terminations, cancellations, or delays. Some contractors have filed, or are in the process of filing, contract claims to recover additional costs.

.04 The U.S. Office of Management and Budget (OMB) released in December 1992 a report entitled "Summary Report of the SWAT Team on Civilian Agency Contracting; Improving Contracting Practices and Management Controls on Cost-Type Federal Contracts." The SWAT Team recommended, among other things, numerous changes to the Federal Acquisition Regulation (FAR) Part 31 cost principles. The SWAT Team's suggested changes currently are being processed through the FAR regulatory structure.

.05 During the six-month period ended March 31, 1993, the Defense Contract Audit Agency (DCAA), the audit arm of the Department of Defense (DOD), disallowed nearly $1.1 billion of incurred costs based on its review of the direct and indirect costs charged to government contracts to determine that the costs are reasonable, allocable, and allowable as prescribed by FAR, the Defense Federal Acquisition Regulation Supplement, and provisions of the contract. Examples of disallowed costs include the following:

- Unreliable and unacceptable data supporting equitable adjustment claims for delays, disruptions, constructive change orders, and unforeseen field conditions
- Incomplete analyses supporting indirect cost charges
- Improper allocation of corporate home office expenses and healthcare costs

Other examples of expressly unallowable costs identified by government auditors included alcoholic beverages, personal use of company automobiles, advertising and trade shows, and scholarships for employee dependents. Compliance with the applicable cost principles and Cost Accounting Standards (CAS) may have a direct effect on the amount of revenue recognized under cost-reimbursement contracts on negotiated contracts when cost or pricing data is submitted.

Regulatory Developments

Cost Accounting Standards Board Initiatives

.06 Applicable laws and regulations regarding CAS and cost allowability may affect the amount of revenue and costs accrued under government contracts depending on the type of contracts involved. AICPA Statement on Auditing Standards (SAS) No. 54, *Illegal Acts by Clients* (AU section 317), requires the auditor to consider laws and regulations that are generally recognized by auditors to have a direct and material effect on the determination of financial statement amounts. Auditors should carefully evaluate the financial statement impact of current CAS and cost allowability (cost principles) on contract revenues and costs, and the impact of any new CAS issued.

.07 The Cost Accounting Standards Board (CASB) continues to examine issues relating to the measurement of costs, the assignment of cost to accounting periods, and the allocation of cost to objectives. In promulgating new or revised CAS, by law the CASB must undertake a four-step process by issuing Staff Discussion Papers, Advance Notices of Proposed Rulemaking (ANPRM), Notices of Proposed Rulemakings (NPRM), and final Rulemakings. This rulemaking process can take several years from development of a staff discussion paper to a final rule.

.08 Below is a summary of current CASB initiatives and their statuses:

Staff Discussion Papers	*Issued*
Asset Revaluations Resulting from Mergers and Business Combinations	August 1991
Contract Price Adjustments for Organizational Changes	April 1993
Revised CASB Disclosure Statement Form	April 1993
Advanced Notice of Proposed Rulemaking	
Composition, Measurement, Adjustment, and Allocation of Pension Costs	January 1993
Notice of Proposed Rulemaking	
Establishment of CAS for Educational Institutions	December 1992
CAS Applicability and Thresholds	April 1993

CASB activities are discussed below in relation to other activities and developments affecting their applicability to government contractors.

.09 *Thresholds for Cost Accounting Standards Coverage.* Public Law (Pub. L.) 100-679 raised the threshold for individual CAS contract coverage from $100,000 to $500,000. However, the law did not address the issue of an increased threshold for the initiation of CAS coverage (the so-called *trigger contract*) or the provision in existing regulation that permits more limited or modified CAS coverage to be applied when the net amount of all government contracts awarded to a contractor segment or business unit does not exceed $10 million a year. These latter thresholds were last established approximately fifteen years ago. In April 1993, the CASB issued a NPRM proposing—

- To raise the threshold for full CAS coverage to $25 million from $10 million.
- To establish a $1 million trigger contract mechanism for the initiation of full CAS coverage.
- To expand requirements for modified CAS coverage to include compliance with CAS 405, *Accounting for Unallowable Costs,* and CAS 406, *Cost Accounting Period.*
- To eliminate the alternative *10 percent or more* government sales test criterion for initiation of full CAS coverage.

- To eliminate the requirement for a separate CASB waiver where the procuring agency has waived the requirement for submission of certified cost or pricing data.

The NPRM is intended to adjust CAS applicability requirements and dollar thresholds to levels reflecting inflation since the thresholds were promulgated by the previous CASB. This proposed change is expected to significantly reduce the administrative burden on smaller contractors with only a relatively small decrease in total dollars of covered contracts.

.10 The concept of modified CAS coverage was designed to address the problems of application of CAS to smaller government contractors and to contractors for whom government business represented only a relatively small share of total sales volume. Under current standards, modified coverage may be awarded to a business unit that received less than $10 million in CAS-covered contracts in the immediately preceding cost accounting period if the sum of such awards was less than 10 percent of the business unit's total sales during that period. Modified coverage requires only that the contractor comply with CAS 401, *Consistency in Estimating, Accumulating and Reporting Costs,* and 402, *Consistency in Allocating Costs Incurred for the Same Purpose.*

.11 The proposed increase of the so-called trigger contract amount is also intended to decrease the burdens associated with the application of full coverage. Under the NPRM, a contractor would be subject to full CAS coverage if it receives $25 million in CAS-covered contracts, including at least one CAS-covered contract of $1 million or more. A contractor with $25 million in CAS-covered contracts valued at $500,000 each, but without a single $1 million contract, would not be subject to full coverage.

.12 The NPRM provides for the continuation of the trigger contract concept, but limits its application exclusively to full CAS coverage. Therefore, the application of modified CAS coverage to an individual contract or subcontract will be determined without reference to the triggering contract mechanism applicable to full CAS coverage.

.13 A final rule on revisions to CAS coverage thresholds may be issued and become effective by the end of 1993.

.14 *Composition, Measurement, Adjustment, and Allocation of Pension Costs.* In January 1993, the CASB issued an ANPRM proposing to revise CAS relating to accounting for pension costs under negotiated government contracts. The CASB proposal includes requirements for the components, measurement, assignment, and allocation of pension costs for qualified and nonqualified defined benefit pension plans. The CASB addressed certain problems that have emerged since the original promulgation of the pension standards, CAS 412, *Cost Accounting Standards for Composition and Measurement of Pension Costs* and CAS 413, *Adjustment and Allocation of Pension Costs.* The ANPRM would: (1) permit deferment of the start-up amortization of actuarial gains and losses for a period of two years, and (2) shorten the amortization period for these gains and losses from the present 15 years to five years. The ANPRM also considers deleting the requirement of funding into a qualified trust in order to make the cost allowable; however, this requirement would be waived only to the extent that funding cannot be accomplished due to Internal Revenue Code limitations. The ANPRM proposes to allow accrual of nonqualified pensions costs, but only to the extent that these costs are funded into a *Rabbi Trust* using the complement of the corporate income tax rate multiplied by these costs. As the result of comments received on the ANPRM, the NPRM on this issue may be changed significantly from the ANPRM.

.15 *Asset Revaluations Resulting from Mergers and Business Combinations.* The CASB continues to study the treatment of gains and losses associated with the revaluation of tangible capital assets following business combinations by government contractors. A CASB Staff Discussion Paper was issued on this subject in August 1991. The CASB staff is expected soon to solicit further public comments on this issue by issuing another staff research paper. A FAR cost principle, Section 31.205-52, *Asset Valuations Resulting from Business Combinations,* is now effective for certain contracts that define as unallowable costs depreciation, amortization, and cost of money on depreciable property and gains and losses on its disposition that result from a business combination when the purchase method of accounting is used and the related assets have been revalued generally leading to a step-up in asset basis.

.16 Guidance issued by the DCAA to its auditors suggests that for business combinations that occurred prior to July 23, 1990 (effective date of FAR 31.205-52), the government contracting officer examine each situation "on a case-by-case basis to achieve equity or protect the government's interests. . . ." DCAA auditors are further instructed to advise the contracting officer to enter into an advance agreement if they encounter prior combinations in which—

- Agreements between the government and the contractor imply the acceptance of the costs into the future.
- The acquired company had little or no government business before being acquired and the "acquiring company subsequently entered government business with the asset valuations established by the combination."
- An extensive amount of time has elapsed between the combinations and the effective date of the cost principle.

The guidance offers five to ten years as a reasonable period of time that should be considered when applying the limitations.

.17 An appeal from a contracting officer's final decision on the issue of applicability has yet to be filed with a board of contract appeals. Independent auditors should be alert to the outcome of any such appeal. Auditors should carefully evaluate the allowability of costs under cost principle 31.205-52, including a review of any agreements between the government and contractor on the treatment of such costs.

.18 *Proposed Revisions to the CASB Disclosure Statement Form.* Contractors with greater than $10 million in government contracts covered by CAS are required to file a disclosure statement containing details of the accounting practices of all recognized business segments doing business with the federal government. In April 1993, the CASB issued a Staff Discussion Paper on a revised draft Cost Accounting Standards Board Disclosure Statement Form (CASB DS-1), which solicited views from the government procurement community with respect to the current format of the Disclosure Statement. Comments were requested by July 2, 1993.

Cost Allowability and Allocability Issues

.19 *Contract Claim Certification.* Rules addressing the certification of contract claims and requests for equitable adjustments were issued by the DOD in May 1993. Those rules state that the person executing the certification must be authorized to bind the contractor and have knowledge of the claim or request, its basis, and the completeness and accuracy of supporting data (DFARS 233.7000; see May 13, 1993 *Federal Register*). Proper certification may affect the contractor's legal entitlement to a claim.

.20 *New DCAA Audit Guidance.* New guidance provided to DCAA auditors in the DCAA Contract Audit Manual focuses on several recommendations of the SWAT Team on Civilian Agency Contracting, including—

- Reasonableness of compensation costs for closely held corporations.
- Voluntary management reductions to claimed indirect cost rates in lieu of separately identifying and segregating unallowable costs in the indirect cost rate proposals.
- Guidance on the definition of *common control* as it relates to limitations on rental charges between organizations.
- Costs of postretirement benefits other than pensions (OPEB) including costs of non-CAS covered contractors electing the so-called *terminal funding* where the contractor accrues and funds the entire cost of a retiree's postretirement benefits upon the employee termination.

- The basis for the federal government to share in excess defined-benefit pension plan assets that revert to a contractor upon termination.
- The federal government's share of any credits received by contractors for airline promotional benefits (that is, frequent flyer bonus credits).

.21 The DCAA also has provided new guidance to its auditors in the following areas:

- Evaluating contractor cost/benefit analysis in support of the use of private aircraft
- Costs associated with political campaign activities at contractor facilities
- Determining if refunds and/or credits are appropriate when the contractor receives foreign tax credits
- Allowability of legal costs relating to bid protests
- Allowability of severance payments and early retirement incentive payments
- Evaluation of environmental costs (see the section that follows on "Environmental Costs")

See the section, "Audit Issues and Developments," for a discussion of allowable and allocable costs charged to contracts.

.22 *Educational Institutions That Receive Federal Research Awards.* Revised guidance on establishing indirect cost rates for educational institutions that are recipients of federal research funds were issued by the OMB in July 1993. Revised OMB Circular A-21, *Cost Principles for Educational Institutions,* is effective for the establishment of indirect cost rates for all fiscal years beginning on or after January 1, 1994, with early implementation encouraged.

.23 In addition to limiting reimbursement of administrative costs to 26 percent of modified total direct costs, the Circular provides guidance on the definition of *organized research* to include both university-supported research and federally sponsored research, allocation methods for depreciation and use of jointly used space, the definition of *modified* total direct costs, the use of provisional rates or fixed rates and carryforward provisions, the development of separate fringe benefit rates where benefits for varying classes of employees vary significantly, and the exclusion of certain costs from indirect rates. The Circular notes that the CASB, which issued a proposed rule in December 1992 to apply CAS to educational institutions awarded federal contracts, is considering rules to apply certain CAS to educational institutions receiving negotiated contract awards in excess of $500,000. The Circular also indicates that the OMB plans, in the near future, to extend the CASB's regulations and standards applicable to educational institutions to all awards (contracts and grants) made to institutions that are major recipients of federal research funds.

.24 Independent auditors should carefully evaluate the financial statement effects of allowable and unallowable indirect costs on revenues, receivables, and income, and be alert to the issuance of additional requirements by the CASB and OMB.

.25 *New Penalties for Unallowable Costs.* Under the 1993 National Defense Authorization Act for Fiscal Year 1993 (Pub. L. 102-484), a number of changes were made to the penalty requirements for unallowable costs. The standard for incurring penalties for submission of unallowable costs was changed from "unallowable based on clear and convincing evidence" to "expressly unallowable" under a specific FAR or DFARS cost principle. Under interim implementing rules contained in Defense Acquisition Circular (DAC) 91-5 issued in May 1993 by the DOD, penalties will be assessed only after the initiation of a formal audit. The penalty amount is equal to the amount of disallowed costs allocated to a DOD contract plus any interest on any paid portion. If the amount is determined to be unallowable before submission of the indirect cost proposal, the penalty amount is limited to twice the amount of the disallowed cost. Penalties may be waived under certain circumstances, including if the amount of the unallowable cost subject to the penalty is insignificant. The DOD has set $10,000 per proposal as a ceiling to determining whether the amount of unallowable cost submitted is "insignificant" (DFARS 231.70).

.26 The revised penalty regulations apply to incurred cost proposals where the government formally initiated an audit of the proposal after October 23, 1992.

.27 Federal legislation (the Contract Costs Act) has been introduced to extend penalties for unallowable costs in indirect cost proposals to civilian agency contractors. The law would apply to all indirect cost settlement proposals submitted more than 210 days after the bill's enactment. Some industry experts expect passage of the bill without substantive amendment later this year.

.28 *Contract Price Adjustments for Organizational Changes.* CAS-covered contractors are required as a condition of contracting with the federal government to disclose their cost accounting practices and to agree to a contract price adjustment for any increased cost paid by the government by reason of a change in those cost accounting practices. Some contractors believe that organizational changes do not equate to a change in cost accounting practice when the method or technique for measurement, assignment, and allocation of costs to cost objectives does not change. In a 1992 Armed Services Board of Contract Appeals (ASBCA) decision concerning Martin Marietta Corp., the ASBCA held that a regrouping of home office cost in business segments as a result of a corporate reorganization did not constitute a change in cost accounting practice in the case of the following:

- The only accounting method or technique used in determining the specific groups was the beneficial or causal relationship test.
- The changes in groups were the result of changes in the beneficial or causal relationships between the home office functions and the various segments of the enterprise and not a result of a change in the accounting method or technique used to determine the groupings.

The decision is pending on appeal before the U.S. Court of Appeals for the Federal Circuit. A CASB Staff Discussion Paper issued in April 1993 solicited views regarding the application of CAS regulations on changes in cost accounting practices in cases where a contractor elects a change to its organizational structure during contract performance.

.29 Independent auditors should be alert to further legal and CASB developments in this area, and carefully evaluate the effect of any organizational changes on contract price adjustments and the related financial statement effect on reported revenues, receivables, and income.

.30 *Environmental Costs.* A proposed environmental cost principle developed last year regarding the allowability of environmental costs has been held up for issuance for public comment by the Clinton Administration. The pending proposal would divide environmental costs into two categories: (1) ongoing prevention and disposal costs, and (2) costs of correcting environmental damage. Costs in the first category generally would be considered allowable. However, allowability of costs in the second category would be based on the contractor's demonstrating that it—

- Was performing government contracts at the time the conditions were created.
- Was conducting business prudently and in compliance with laws and regulations.
- Acted promptly to minimize damage.
- Has diligently pursued legal and contributory sources (for example, insurance, or indemnification) to defray the cost.

.31 Also, the Defense Logistics Agency's Defense Contract Management Command and the DCAA have begun a joint audit of environmental costs at five contractor locations to determine the allowability of the costs, with the aim of developing agency-wide guidance and procedures regarding the allowability of contractors' environmental costs included in overhead proposals.

.32 Auditors should be alert to the issuance of any new regulations or guidelines in this area.

.33 *Legislative Lobbying Costs.* DAC 91-5 makes unallowable the cost of preparing any material, report, lists, or analysis on the actual or projected economic or employment impact in a particular state or congressional district of an acquisition program for which all research and development, testing and evaluation has not been completed.

Audit Issues and Developments

Claims, Change Orders, and Requests for Equitable Adjustment

.34 In the current environment, it is likely that contractors will encounter significantly more claims activity, either with the government or subcontractors. Auditors should discuss with appropriate client personnel the need for an opinion of legal counsel to support claims, Requests for Equitable Adjustment (REAs), and, where necessary, unnegotiated change orders, and should consider the contractor's past history in negotiating similar claims, REAs, and unnegotiated change orders when evaluating the estimated net realizable value of such amounts. Auditors should refer to the criteria for recognizing claims as set forth in the AICPA Audit and Accounting Guide *Audits of Federal Government Contractors.* Auditors should also consider the adequacy of financial statement disclosure for significant claims, REAs, and unnegotiated change orders.

Allowable and Allocable Costs Charged to Contracts

.35 Government auditors continue to question or disallow direct or indirect costs charged to government contracts based upon whether the costs are reasonable, allocable, and allowable as prescribed by the FAR, provisions of the contract, and other applicable regulations and requirements. Laws and regulations regarding cost allowability and allocability affect the amount of revenue and costs accrued under government contracts depending upon the type of contract, and thus compliance with the applicable cost principle or CAS may have a direct effect on the amount of revenue and costs recognized. SAS No. 54 (AU section 317) provides guidance on the nature and extent of the considerations the independent auditor should give to the possibility of illegal acts by clients. The auditor considers laws and regulations that are generally recognized to have a direct and material effect on the determination of financial statement amounts. Auditors should carefully evaluate the allowability and allocability of amounts to government contract costs.

.36 *High-Risk Contracts.* Contractors occasionally experience difficulty in performing on certain contracts and may believe that the government may be responsible to some extent for the problems. In those instances, contractors may include the effect of claims or other adjustments that they believe will result in additional revenues from the government in their estimates at completion. Such claims and adjustments may reduce the amount of the estimated loss on such contracts or avoid a reduction in the level of profit recognized. As a result, auditors should critically evaluate the evidence supporting the contractor's basis for claims and adjustments, especially in contracts on which the contractor is known to have had difficulty performing. Auditors should also carefully consider the adequacy of the financial statement disclosure of significant claims and unnegotiated change orders.

.37 *Cost in Excess of Contractual Funding.* Many contractors, for various business reasons, will continue to perform on a contract and incur costs in excess of the government's current appropriation of funds. Auditors should carefully review such costs for recoverability and consider the potential need for a reserve against the ultimate collectibility of such costs.

Accounting Issues and Developments

Postretirement Benefits Other Than Pensions

.38 Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions* (AC P40), is likely to create OPEB cost that is greater than the expense allowed as a contract cost used to determine contract revenue. The full amount calculated in accordance with generally accepted accounting principles may be allowable if the contractor has elected to fully fund it and has used the cumulative-effect method in a prior year to adopt FASB Statement No. 106 (AC P40). A number of issues, including tax laws regarding deductibility of OPEB costs, changes in CAS, funding, negotiation of forward pricing arrangements with respect to OPEB expenses, and the timing of adoption of FASB Statement No. 106 (AC P40), may further complicate the allowability of such costs. In addition, auditors should be aware that the DCAA has taken the position that a change from the pay-as-you-go method of accounting for OPEB costs to that required by FASB Statement No. 106 (AC P40) may result in a change in costs accounting practice for contract costing purposes, which would result in the disallowance of any increased costs allocated to current contracts, including cost-type contracts. Some industry experts disagree with the DCAA's position.

.39 Some contractors have, on adoption of FASB Statement No. 106 (AC P40), recorded a related asset. The future recoverability of such an asset, and the timing thereof, may have a significant degree of uncertainty resulting from—

1. The current industry environment and related business-base concerns when the OPEB expense is projected to be recovered via contract costing.
2. The computations and assumptions used (including the amounts and years in which the amounts are recovered) to support the asset, which may be subjective. For example, given the current environment, questions arise of whether future contract values should include funded backlog, total contract backlog, loss contracts, contracts with small margins, or contract options.

Because of the significance of the uncertainties, auditors should carefully consider the appropriateness of recording any deferred costs (or, alternatively, revenues accrued) by contractors to account for the difference between FASB Statement No. 106 (AC P40) and CAS requirements related to OPEB costs. The staff of the Securities and Exchange Commission has indicated that it will scrutinize the realizability of such assets and look for sufficient disclosure in the registrant's Management Discussion and Analysis regarding the uncertainties related to recovery of the asset.

Commercial Nonrecurring Costs

.40 Many federal government contractors are moving into commercial markets and increasingly are using the program method of accounting for products manufactured for delivery under production-type contracts, which may result in the deferral of costs. Under this method, costs are accumulated and accounted for by programs rather than by individual units or contracts. A program consists of the *estimated* number of units of a product to be produced by an enterprise in a continuing, long-term production effort for delivery under existing and anticipated contracts. Auditors should be aware that the Audit and Accounting Guide *Audits of Federal Government Contractors* states that program accounting has had very limited applications because of the significant uncertainties associated with making reasonably dependable estimates of the total number of units to be produced and sold, the length of time to produce and sell them, and the associated production costs and selling prices. Additionally, the recoverability of the deferred costs is subject to a greater degree of risk and, accordingly, becomes more difficult to estimate in the current uncertain business environment. Program accounting is further discussed in paragraphs 3.57 through 3.60 of *Audits of Federal Government Contractors.*

Environmental Costs

.41 Contractors increasingly are faced with significant costs related to environmental cleanup activities. In some cases, contractors may be able to recover all or a portion of these costs depending on the treatment of the costs in future overhead rates. Auditors should consider the treatment of cleanup costs in future overhead rates when assessing a contractor's financial reporting related to environmental cleanup matters. *Audit Risk Alert—1993* [AAM section 8010] includes additional information on accounting for and disclosure of environmental cleanup costs.

Business Restructurings

.42 The uncertain economic and business environment is necessitating the reorganization, restructuring, and downsizing of many government contractors.

.43 Contractors involved in business restructurings are finding it advantageous to secure advance agreements with the government for the treatment of such costs. However, there are still conflicts between GAAP and the FAR related to the accounting treatment of certain items, such as pension curtailments and settlements. Auditors should be aware of these differences and should consider the related accounting and reporting issues involved in business restructurings of government contractors.

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.44 This Audit Risk Alert replaces *Federal Government Contractors Industry Developments—1992.*

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.45 Auditors should also be aware of the economic, regulatory, and professional developments that may affect the audits they perform, as described in *Audit Risk Alert—1993* [AAM section 8010].

[The next page is 8285.]

AAM Section 8140

Finance Companies Industry Developments—1993

Industry and Economic Developments

.01 Finance companies provide a wide variety of lending and financing services to both consumers and business enterprises. Some limit their lending activities to financing purchases of products produced by an affiliated company. Others concentrate on lending to consumers. Still others have diversified into higher risk lending to real estate and takeover ventures and have come to compete with banks and savings institutions.

.02 Finance companies, along with most other lenders, are reaping the benefits of an economic environment characterized by a wide interest-rate spread—the differential between the rate paid to raise capital to lend and the rates charged to borrowers. The primary activity of finance companies is borrowing money at wholesale and lending it at retail. Thus, the ability to raise capital at some of the lowest rates in years and to lend that money out at relatively high rates has boosted earnings virtually throughout the industry to near-record levels.

.03 Credit quality, while still a major concern for lenders of all sorts, has also taken a turn for the better. Delinquencies have continued on a downward trend for the first three quarters of the year and are expected to stay that course for the remainder of the year.

.04 Loan volume, which became somewhat soft in recent years as consumers pared down their debt levels, is nevertheless expected to increase in response to developments such as increases in consumers' disposable income and the improved affordability of housing. Loan demand at banks and savings institutions continues to be weak. Corporations have been implementing fundamental changes in financing policies. The policy changes include a drive by corporations to reduce debt, and greater use by medium-size corporations of nonbank borrowings such as leases, private placements of debt, and sales of corporate securities in the bond and commercial paper markets. As a result, corporations that formerly dealt only with banks are now turning to commercial finance companies.

.05 The low-inflation, low-interest rate environment has also proved beneficial to companies with real-estate related activities such as mortgage origination, refinancing, and servicing.

.06 Auditors of finance companies should fully understand the kinds of lending activities in which their clients are engaged and carefully consider the risks inherent in each. Auditors should also be alert to red flags that indicate areas of increased risk requiring particular audit consideration. Such red flags include—

- Changes in loan acceptance policies attributable to increased competition, possibly resulting in the acceptance of higher risk loans.
- Material changes in operations or operating performance that may indicate deteriorating financial strength. Such changes include increasing loan delinquencies or loss charge-offs, declining interest spreads, lower ratios of loan-loss allowances to nonperforming loans in comparison to industry averages, and practices that reflect a failure to consider changing economic conditions (for example, inappropriately heavy reliance on historical data in evaluating allowances for loan losses).
- Material, one-time transactions that may indicate attempts to realize large, short-term benefits, particularly when such transactions occur at or near the end of a reporting period or account for a material portion of reported income. Such transactions may include high-volume purchases or sales of assets (such as mortgage-servicing rights), speculative or unusual off-balance-sheet arrangements, and other high rates of asset growth or disposition. Auditors should give particular attention to the propriety of the accounting treatment of such transactions.

- Highly complex or speculative investments, such as complex mortgage derivatives, investments in noninvestment-grade securities, or complicated, multiple-step transactions involving real estate. Auditors should consider the propriety of management's valuation of such investments and evaluate management's assessment of their recoverability.

- Nontraditional or unusual loan transactions that may expose the company to increased risk. Such transactions include loans with unusual, questionable, or inadequate collateral; loans outside the company's normal lending area; poorly documented loans; loans that pay interest from interest reserves; loans secured by collateral that has dramatically changed in value; significant concentrations of loans; loans to real estate ventures that represent equity investments (acquisition, development, and construction loans); and practices such as routine extension or modification of loan terms or lending activity inconsistent with the stated policies of management.

Regulatory Developments

.07 AICPA Statement on Auditing Standards (SAS) No. 22, *Planning and Supervision* (AU section 311), requires that in planning their audits, auditors consider matters affecting the industry in which the entity operates including, among other things, government regulations. Auditors consider such regulations in light of their potential impact on the financial statements being audited. SAS No. 54, *Illegal Acts by Clients* (AU section 317), distinguishes between the following two types of laws and regulations:

1. Those that have a direct and material effect on the determination of financial statement amounts

2. Those that relate more to an entity's operating aspects than to its financial and accounting aspects and, therefore, have only an indirect effect on the financial statements

Although auditors should design their audits to provide reasonable assurance of detecting material misstatements of the financial statements resulting from illegal acts that have a direct and material effect on the determination of financial statement amounts, an audit performed in accordance with generally accepted auditing standards does not include procedures specifically designed to detect illegal acts that would have only an indirect effect on the financial statements. Nonetheless, auditors should be aware of the possibility that such illegal acts may have occurred.

.08 Finance companies and the transactions in which they engage have become the focus of increasing governmental regulation. Laws and regulations that affect the finance companies industry are discussed below and in the AICPA Audit and Accounting Guide *Audits of Finance Companies (Including Independent and Captive Financing Activities of Other Companies).*

Regulation Z of the Consumer Credit Protection Act

.09 Truth-in-lending laws can have a significant effect on the operations of financing transactions. Regulation Z prescribes requirements for both creditors and borrowers for full disclosure of credit costs and is applicable to all real estate transactions, regardless of amount, in which individual borrowers are involved in nonbusiness transactions.

Audit Issues and Developments

Credit Quality

.10 Credit quality has begun to show signs of improvement for many finance companies. Nevertheless, credit quality and other asset quality issues associated with loans, real estate portfolios, troubled debt restructurings, foreclosures and in-substance foreclosures, off-balance-sheet financial instruments, and other assets require critical attention in audits of the financial statements of finance companies, especially those that have diversified into higher-risk lending activities. Auditors should obtain reasonable assurance that management has recorded adequate asset valuation allowances and liabilities for other credit exposures based on all relevant factors. The subjectivity of determining asset valuation allowances, combined with continued economic uncertainty, reinforces the need for careful planning and execution of audit procedures in this area.

.11 Lack of an asset impairment evaluation system or failure of a finance company to document adequately its criteria and methods for determining asset valuation allowances may indicate a material weakness in the internal control structure and will generally increase the extent of judgment that must be applied by auditors in evaluating the adequacy of management's allowances and will increase the likelihood that differences will result. The guidance in SAS No. 57, *Auditing Accounting Estimates* (AU section 317), should be followed in auditing asset valuation allowances. Other sources of information on auditing loan loss allowances include the AICPA Audit and Accounting Guides *Audits of Savings Institutions* and *Audits of Credit Unions*, the Industry Audit Guide *Audits of Banks*, and the Auditing Procedure Study, *Auditing the Allowance for Credit Losses of Banks*. The Audit and Accounting Guide *Guide for the Use of Real Estate Appraisal Information* provides guidance to help auditors understand real estate appraisal concepts and information.

.12 As with credit risk, other valuation issues involve many subjective assumptions. For example, the expected effects of prepayments on loans in portfolios and the types of income and expense items included in valuations of loan servicing assets have a significant impact on the recorded values of those assets. High levels of prepayments of mortgage loans, for example, have resulted in the impairment of many assets, such as purchased mortgage servicing receivables and interest-only securities. Evaluation and recognition of impairment attributable to prepayments should include consideration of the entity's aggregation policy, discount rates, and assumptions about the future prepayment rates.

.13 Further, falling interest rates have created an environment in which transactions involving gains trading of securities, refinancing of loans, restructuring of nonperforming assets, origination of loans to facilitate the sale of real estate owned, and other asset dispositions all require specific attention. Such transactions require an understanding of the specific situations so that the auditor may carefully assess and control audit risk.

.14 *Derivatives and Other High-Risk Investments.* In recent years there has been a growing use of innovative financial instruments that often are very complex and can involve a substantial risk of loss. Users and issuers of such instruments must have the expertise necessary to understand and manage the related risks. As discussed below, auditors should also be familiar with such instruments and the associated risks. One class of these instruments—derivatives—requires particular attention.

.15 Derivatives are complex financial instruments whose values depend on the values of one or more underlying assets or financial indexes. Derivatives generally fall into at least two categories:

1. Asset-backed securities, which include mortgage-backed securities, interest-only and principal-only strips, and tranches of collateralized mortgage obligations.

2. Off-balance-sheet instruments such as forward contracts, interest-rate and currency swaps, futures, options, and other financial contracts.

By reconfiguring cash flows associated with underlying assets, an issuer can create asset-backed securities that meet the needs of, and are attractive to, various potential users by isolating, enhancing, or diluting one or more of credit, liquidity, interest-rate and other risks inherent in the underlying cash flows. For example, through mortgage-backed securities, the issuer can enhance the marketability of underlying mortgage loans by spreading liquidity and credit risk across broad pools, or by providing a higher yield to those users willing to accept a higher concentration of the risks associated with specific collateral cash flows. Similarly, users find certain derivatives attractive because they can purchase the risks and rewards they desire most, or can synthetically create a security with the desired risk and reward characteristics.

.16 Increased volatility of interest rates, foreign exchange rates, and commodity and other prices has also fostered tremendous innovation in financial products to meet the needs of users attempting to hedge or alter the related risks. Swaps, for example, are financial contracts in which two parties exchange streams of payments over a period of time. An entity with debt that carries variable interest rates (such as an entity that has short-term certificates of deposit) might swap interest-rate payments on an agreed-upon principal amount with a counter-party by paying a fixed rate and receiving a variable rate. The entity locks into an interest rate for the term of the swap, reducing the risk that increases in interest rates will increase the entity's cost of funds as its liabilities are refunded or related interest rates are reset. The entity takes on other risks, however, such as the risk that the counter-party could default on its payments. By locking into fixed rates, the entity will no longer benefit from interest-rate decreases during the term of the swap, and it is often costly to terminate a swap. Further, the fair value of derivatives can be volatile in periods of changing market conditions.

.17 *Accounting.* Accounting for derivatives is complex. Given the constant innovation and complexity of derivatives, accounting literature does not explicitly cover some derivatives; however, several related projects are underway.

.18 The Financial Accounting Standards Board (FASB) has been carrying out a major project on the recognition and measurement of financial instruments, which has already resulted in the issuance of FASB Statements of Financial Accounting Standards No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*; No. 107, *Disclosures about Fair Value of Financial Instruments*; No. 115, *Accounting for Certain Investments in Debt and Equity Securities*; and FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*, that address related issues. The FASB's project includes a comprehensive review of accounting for hedging and risk-adjusting derivatives. Also, the International Accounting Standards Committee is in the process of developing an international accounting standard for financial instruments.

.19 Several accounting issues involving derivatives have also been addressed by the FASB's Emerging Issues Task Force (EITF). Other guidance is provided by FASB Statements No. 52, *Foreign Currency Translation*, and No. 80, *Accounting for Futures Contracts*. In addition, AICPA Issues Paper No. 86-2, *Accounting for Options*, discusses various matters relating to options.

.20 *Auditing.* The innovative and complex nature of such investment vehicles may significantly increase audit risk. For example, as more and more financial institutions enter the markets for such instruments, their profitability may diminish. Traders may attempt to compensate for the diminution by increasing the volume of transactions involving such instruments or by further customizing products. An increase in volume may be accompanied by trading with counter-parties that have higher credit risk. Customizing transactions may increase valuation difficulties. The propriety of the methods used by the managements of finance companies to account for transactions involving sophisticated financial instruments and to determine their value should be carefully considered. Understanding the substance of transactions in such instruments is important in determining the propriety of their accounting treatment. In some circumstances, auditors may find it helpful to consult with experts.

.21 SAS No. 22 requires that auditors understand the events, transactions, and practices that, in their judgment, may have a significant effect on the financial statements. Accordingly, auditors should carefully consider the various risks involved with investments in derivatives and other complex securities as they plan their audits and should—

1. Assess management's expertise in monitoring, evaluating, and accounting for the securities.
2. Ensure that the entity has set appropriate policies and procedures for investment in high-risk securities and that there is adequate oversight by the board of directors.
3. Involve specialists, when necessary, in valuing and auditing these investments.

.22 *Service-Center-Produced Records.* Finance companies frequently operate in an environment in which service organizations play a critical role in the accounting function. In assessing control risk in such an environment, auditors must carefully consider the functions or processing of information performed by the service organizations. SAS No. 70, *Reports on the Processing of Transactions by Service Organizations,* which was issued in April 1992 and supersedes SAS No. 44, *Special-Purpose Reports on Internal Accounting Control at Service Organizations,* provides guidance to auditors performing audits of finance companies that use such organizations.

.23 When a finance company uses a service organization, the functions or processing performed by the service organization may have a significant effect on the finance company's financial statements. Because the processing may be subjected to control policies and procedures that are physically and operationally separate from the finance company, the internal control structure of the finance company may include a component that is not directly under the control and monitoring of its management. SAS No. 55, *Consideration of an Entity's Internal Control Structure in a Financial Statement Audit* (AU section 319), requires an auditor to obtain a sufficient understanding of an entity's internal control structure to plan an audit. For this reason, planning the audit of a finance company may require that the auditor gain an understanding of the control policies and procedures performed by service organizations. When a finance company relies on a service organization's control policies and procedures over the processing of transactions that are material to the finance company's financial statements, those control procedures should be considered by the auditor. One method of obtaining information about those policies and procedures is to obtain a service auditor's report as described in SAS No. 70 (AU section 324).

.24 Auditors frequently inquire whether it is necessary to obtain a service auditor's report when their clients use service organizations. The fact that an entity uses such an organization does not, in itself, require that such a report must be obtained. In certain situations, the finance company may implement control policies and procedures that will obviate the need for a service auditor's report. For example, a finance company using a payroll service may routinely compare the data submitted to the service organization with reports received from the service organization to check the completeness and accuracy of the data processed. The finance company may also recompute a sample of the payroll checks for clerical accuracy and review the total payroll for reasonableness. In such circumstances, the finance company is not relying on the service organization's controls.

.25 Other factors that may be considered in determining whether to obtain a service auditor's report are—

- Whether the transactions or accounts affected by the service organization are material to the finance company's financial statements.
- The extent to which the user organization retains responsibility for authorizing the transactions and maintaining the related accountability.
- The availability of other information (for example, user manuals, system overviews, and technical manuals) at the finance company that may provide the auditor with sufficient information to plan the audit.

The AICPA's Auditing Standards Division expects to issue an Auditing Procedure Study *Implementing SAS No. 70, Reports on the Processing of Transactions by Service Organizations,* early in 1994.

Accounting Developments

FASB Financial Instruments Project

.26 The FASB's agenda continues to include a project on financial instruments that encompasses three primary segments: disclosures, distinguishing between liabilities and equity, and recognition and measurement. In addition to these three primary segments, the FASB has addressed several narrower issues within the overall scope of the project. Some of the current developments of the project are described in the following sections.

.27 *Impairment of a Loan.* In May 1993, the FASB issued FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan* (AC I08), which addresses the accounting by creditors for impairment of certain loans. The Statement is applicable to all creditors and to all loans, uncollateralized as well as collateralized, except large groups of smaller balance homogeneous loans that are collectively valued for impairment, loans that are measured at fair value or at the lower of cost or fair value, leases, and debt securities as defined in FASB Statement No. 115 (AC I80). It applies to all loans that are restructured in a troubled debt restructuring involving a modification of terms.

.28 FASB Statement No. 114 (AC I08) requires that impaired loans that are within its scope be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or as a practical expedient, at the loan's observable market price or the fair value of collateral if the loan is collateral-dependent.

.29 The Statement amends FASB Statement No. 5, *Accounting for Contingencies* (AC C59), to clarify that a creditor should evaluate the collectibility of both contractual interest and contractual principal of all receivables when assessing the need for a loss accrual. The Statement also amends FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructuring* (AC D22), to require a creditor to measure all loans that are restructured in a troubled debt restructuring involving a modification of terms in accordance with its provisions.

.30 The Statement applies to financial statements for fiscal years beginning after December 15, 1994. Earlier application is encouraged.

.31 Sources of guidance relevant to auditing loan loss allowances are described in paragraph .11.

.32 Some finance companies may adopt the provisions of the Statement prior to its effective date. Auditors of the financial statements of such finance companies should carefully consider the implications of applying the new provisions of the Statement on audit risk. Aspects of applying the new Statement that warrant particular consideration include—

- Proper identification of all loans to which the Statement should be applied.
- The reasonableness of estimates of future cash flows and interest rates used in discounting.
- The appropriateness of amounts used to measure impairment if alternatives to present value amounts, such as fair values of collateral or observable market prices, are used.
- The relationship between the identification of impaired loans under the Statement and the classification of loans under regulatory classification systems.
- The presentation of accrued interest receivable and its relationship to valuation allowances.
- The relevance of concepts of performing and nonperforming assets.

.33 *Investments in Debt and Equity Securities.* In May 1993, the FASB issued FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (AC I80), which addresses the accounting and reporting for investments in equity securities that have readily determinable fair values (previously addressed by FASB Statement No. 12, *Accounting for Certain Marketable Equity Securities* [AC I89]) and for all investments in debt securities. FASB Statement No. 115 (AC I80) does not cover securities accounted for by the equity method and investments in consolidated subsidiaries. FASB Statement No. 115 (AC I80) establishes three categories of reporting debt and marketable equity securities:

- Held-to-maturity securities (debt securities that the entity has the positive intent and ability to hold to maturity), to be reported at amortized cost
- Trading securities (debt and equity securities that are bought and held principally for the purpose of selling them in the near future), to be reported at fair value, with unrealized gains and losses included in earnings

- Available-for-sale securities (debt and equity securities not classified as either held-to-maturity or trading), to be reported at fair value, with unrealized gains and losses excluded from earnings and reported in a separate component of equity until realized

Mortgage-backed securities that are held for sale in conjunction with mortgage-banking activities (as described in FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities* [AC Mo4]), are classified as trading securities. Mortgage-backed securities that are currently not held-for-sale in conjunction with mortgage-banking activities may be classified in one of the two other categories, as appropriate.

.34 FASB Statement No. 115 (AC I80) also requires finance companies to determine whether declines in the fair value of individual securities classified as either held-to-maturity or available-for-sale below their amortized cost bases are other than temporary. For example, if it is probable that an investor will be unable to collect all amounts due according to the contractual terms of a debt security not impaired at acquisition, an other-than-temporary impairment is considered to have occurred. If such a decline is judged to be other than temporary, the cost basis of the individual security should be written down to fair value as the new cost basis, with the amount of the write-down included in earnings (that is, accounted for as a realized loss).

.35 The Statement also specifies the accounting treatment for transfers between categories.

.36 The Statement (paragraph 8 [AC I80.105]) indicates that certain changes in circumstances may cause the enterprise to change its intent to hold a certain security to maturity without calling into question its intent to hold other debt securities to maturity in the future. Such circumstances include evidence of a significant deterioration in the issuer's creditworthiness or a change in tax law that eliminates or reduces the tax-exempt status of interest on the debt security. In addition, other events that are isolated, nonrecurring, and unusual for the reporting enterprise that could not have been reasonably anticipated may cause an enterprise to sell or transfer a held-to-maturity security without necessarily calling into question its intent to hold other debt securities to maturity. Such sales and transfers of held-to-maturity securities are expected to be rare.

.37 An entity shall not classify a debt security as held-to-maturity if it has the intent to hold the security for only an indefinite period. Consequently, a debt security should not, for example, be classified as a held-to-maturity if the enterprise anticipates that the security would be available to be sold in response to changes in market interest rates and related changes in the security's prepayment risk, needs for liquidity, changes in the availability of and the yield on alternative investments, changes in funding sources and terms, and changes in foreign-currency risk.

.38 FASB Statement No. 115 (AC I80) is effective for fiscal years beginning after December 15, 1993. It specifically prohibits retroactive restatement of prior financial statements. Although typically FASB Statement No. 115 (AC I80) would be initially applied as of the beginning of a fiscal year (such as January 1, 1994), entities are permitted to initially apply the Statement as of the end of an earlier annual period for which financial statements have not been issued (with no restatement of interim periods).

.39 Since all finance companies with a calendar fiscal year must classify their investments in securities in accordance with FASB Statement No. 115 (AC I80) as of January 1, 1994, those finance companies will also be able to apply the Statement as of December 31, 1993, if they wish to do so in their 1993 annual financial statements. Thus, auditors should be aware of some of the issues that are likely to arise when the Statement is applied. Auditing financial statements involving the classification of investments in debt and equity securities pursuant to FASB Statement No. 115 (AC I80) may involve a high degree of judgment about such matters as the following:

- How auditors should evaluate subjective exceptions for sales of securities designated as held-to-maturity (including the interpretation of restrictive terms such as *isolated, nonrecurring,* and *unusual*)
- How auditors should evaluate the ability of a finance company to hold securities to maturity, particularly when going-concern issues arise

- Whether cash flow projections are needed in conjunction with assessing a finance company's ability to hold securities to maturity
- How to evaluate whether impairments of investments are other than temporary

Consensus Decisions of the FASB's Emerging Issues Task Force

.40 The FASB's EITF frequently discusses accounting issues involving financial instruments, real estate, or transactions of similar importance to finance companies.

.41 In Issue No. 93-1, *Accounting for Individual Credit Card Acquisitions,* the EITF reached a consensus that credit card accounts acquired individually should be accounted for as originations under FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs for Leases* (AC L20), and EITF Issue 92-5 (see the following discussion).

.42 In Issue No. 92-10, *Loan Acquisitions Involving Table Funding Arrangements,* the EITF reached a consensus that a mortgage loan acquired by a mortgage banking enterprise in a table funding arrangement should be accounted for as a purchase of the loan if the loan is legally structured as an origination by the correspondent and if the correspondent is independent of the mortgage banking enterprise. If any criterion set forth in the consensus is not met, the loan should be accounted for by the mortgage banking enterprise as an originated loan.

.43 In Issue No. 92-5, *Amortization Period for Net Deferred Credit Card Origination Costs,* the EITF reached a consensus that credit card origination costs that qualify for deferral pursuant to paragraph 6 of FASB Statement No. 91 (AC L20.105) should be netted against the related credit card fee, if any, and the net amount should be amortized on a straight-line basis over the privilege period. If a significant fee (relative to the related costs) is charged, the privilege period is the period during which the fee entitles the cardholder to use the card. If there is no significant fee, the privilege period should be one year.

.44 In addition, the EITF reached a consensus that for both purchased and originated credit cards, an entity should disclose its accounting policy, the net amount capitalized at the balance sheet date, and the amortization period(s) of credit card fees and costs.

.45 In Issue No. 92-2, *Measuring Loss Accruals by Transferors for Transfers of Receivables with Recourse,* the EITF reached a consensus that the obligation recorded at the date of sale in connection with the recourse provisions of a transfer of receivables should include all probable losses over the life of the receivables transferred and not only those measured in conformity with FASB Statement No. 5 (AC C59) prior to the date of transfer. The EITF also reached a consensus that recognition of the recourse obligation on a present value basis, as defined, would be acceptable if the timing of the estimated cash flows can be reasonably estimated.

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.46 This Audit Risk Alert replaces *Finance Companies Industry Developments—1992.*

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.47 Auditors should also be aware of the economic, regulatory, and professional developments that may affect the audits they perform, as described in *Audit Risk Alert—1993* [AAM section 8010].

[The next page is 8311.]

AAM Section 8150

Investment Companies Industry Developments—1993

Industry and Economic Developments

.01 The investment companies industry continued to experience phenomenal growth throughout much of 1993. During the first six months of 1993, over $121 billion was invested in mutual funds, bringing total net assets of all funds to over $1.6 trillion.

.02 Much of the increase comes from investors moving their savings from banks and savings institutions to mutual funds in search of higher returns. Between December 1992 and September 1993, the federal funds rate slipped to less than 3 percent for the first time in twenty-nine years. Treasury bill rates continued to decline below 3 percent through September 10, 1993, the lowest level in almost thirty years.

.03 Use of mutual funds as investment vehicles by a growing number of employee-directed pension plans has also contributed to the influx of funds. As this growth continues, the issues faced by auditors of financial statements of investment companies continue to increase in complexity and an awareness of the overall business of investment management, and of the risks inherent in operating in the industry, takes on added importance.

.04 This growth has heightened competition for investment dollars. New techniques developed to meet this challenge and enhance investment performance raise a number of complex regulatory, tax, auditing, and accounting issues.

.05 Two trends in particular seem to be dominating recent product offerings by investment companies: the globalization of investment portfolios and the use of derivative financial instruments.

Globalization of Investment Portfolios

.06 Total assets of U.S. funds invested in foreign equities and bonds increased from $44.1 billion at December 31, 1991, to $74.6 billion at December 31, 1992, as investors chose to participate in the growth of capitalism outside of the United States. Auditors should be alert to factors that may affect financial statements of entities with foreign investments, such as currency risk, foreign taxation, and obtaining reliable market values. AICPA Statement of Position (SOP) 93-4, *Foreign Currency Accounting and Financial Statement Presentation for Investment Companies,* which is discussed further in the Accounting Developments section of this Audit Risk Alert, provides guidance on those factors.

Derivative Financial Instruments

.07 Mutual funds that invest in more volatile and riskier securities are continuing to increase in popularity. Derivatives are complex financial instruments whose value depends on the values of one or more underlying assets or financial indices. Derivatives include financial futures contracts, forward foreign currency contracts, and options contracts, among others. Auditors should consider the unique risks inherent in investing in derivatives and other complex securities as they plan and perform their audits. A further discussion of those risks is included in the Audit Issues section of this Audit Risk Alert.

Regulatory Developments

.08 AICPA Statement on Auditing Standards (SAS) No. 22, *Planning and Supervision* (AU section 311), requires that in planning their audits, auditors consider matters affecting the industry in which an entity operates, including, among other things, government regulations. Auditors consider such regulations in light of their potential impact on the financial statements being audited. SAS No. 54, *Illegal Acts by Clients* (AU section 317), distinguishes between two types of laws and regulations:

1. Those that have a direct and material effect on the determination of financial statement amounts

2. Those that relate more to an entity's operating aspects than to its financial and accounting aspects and therefore have only an indirect effect on the financial statements

While auditors should design their audits to provide reasonable assurance of detecting material misstatements of the financial statements resulting from illegal acts that have a direct and material effect on the determination of financial statement amounts, an audit performed in accordance with generally accepted auditing standards (GAAS) does not include procedures specifically designed to detect illegal acts that would have only an indirect effect on the financial statements. Nonetheless, auditors should be aware of the possibility that such illegal acts may have occurred.

.09 Regulation of investment companies is discussed in chapter 1 of the AICPA Audit and Accounting Guide *Audits of Investment Companies.* The following discussion is intended to help auditors stay abreast of developments that affect the regulation of investment companies.

Securities and Exchange Commission Releases

.10 *Securities and Exchange Commission Release No. IC-19382.* In this release, the Securities and Exchange Commission (SEC) adopted rule and form amendments under the Securities Act of 1933 and the Investment Company Act of 1940. The amendments adopted in this release are intended to improve disclosure of the performance of open-end investment companies in their prospectuses and annual reports to shareholders. Under the amendments, mutual funds are required to include in their prospectuses, or alternatively, in their annual reports to shareholders (1) a discussion of those factors, strategies, and techniques that materially affected their performance during the most recently completed fiscal year, and (2) a line graph comparing their performance to that of an appropriate broad-based securities market index. In addition, the amendments revise the content and format of the condensed financial information contained in the prospectus and require disclosure about portfolio managers. The amendments are intended to provide investors with additional information concerning mutual fund performance and the individuals responsible for that performance. The amendments became effective for filings made by most (but not all) mutual funds on or after July 1, 1993.

.11 *SEC Release No. IC-19399.* On April 17, 1993, the SEC issued Release No. IC-19399 which permits closed-end investment companies to periodically repurchase their shares.

Other SEC Concerns

.12 The SEC's Division of Investment Management has noted, in various public forums, the following matters (paragraphs .13-.17) that frequently give rise to comments on materials filed with the Commission:

.13 *Directed Brokerage Arrangements.* Directed brokerage arrangements (commonly referred to as soft dollar arrangements) usually provide that if an agreed-upon level of commissions on security trades is directed to a broker by a mutual fund manager, the broker will supply investment research or pay expenses on behalf of the mutual fund at no additional charge. To the extent that expenses paid on behalf of funds under soft dollar arrangements are included in the cost of securities as brokerage commissions rather than as expenses, the funds' financial statements are distorted. This may be particularly significant considering the wide circulation given to statistics such as expense ratios within the mutual fund industry. The SEC staff is considering whether to amend its rules on accounting for soft dollar arrangements. In a February 1993 letter to the industry, the SEC staff stated that, at a minimum, the amount paid for goods and services by third parties under brokerage arrangements should be disclosed in the fee table prescribed by item 2 of Form N-1A and item 3 of Forms N-3 and N-4 and on the face of the Statement of Operations.

.14 In evaluating the adequacy of financial statement disclosures, auditors should be alert to disclosure of such arrangements. Failure to disclose material offsets can affect key mutual fund performance statistics, such as selected per-share amounts and operating and expense ratios. The value of such expense reductions may be difficult to estimate, and fund boards of directors should validate such estimates at least annually by approving them as being in the best interests of shareholders.

.15 *Postmerger Performance.* Following the merger of two or more mutual funds, the historical performance of the continuing entity should be based on the historical financial statements of the surviving entity. Determination of which entity is the surviving entity in a merger of mutual funds is based primarily on qualitative measures reflecting the actual operations of the survivor compared to each constituent entity to the merger. Although the legal survivor is often the accounting survivor, this is not always the case. Similarly, the larger entity's operations may not be continued by the survivor. Auditors of mutual funds involved in merger transactions should refer to paragraphs 8.27 through 8.31 of the Audit and Accounting Guide *Audits of Investment Companies* for further guidance.

.16 *Cash Collateral.* Transactions in which a fund lends securities and receives securities as collateral generally are treated as off-balance-sheet transactions. However, any cash received as collateral for such loans is recorded as an asset of the fund and the investment of the collateral cash is subject to the same limitations as are the fund's investments. The SEC staff believes that income from such arrangements should not be offset against custody charges for financial reporting purposes because that would misstate such expenses; rather, it should be reflected separately as a part of investment income.

.17 *Pooled Arrangements.* Pooled arrangements, in which a number of funds deposit cash in managed pools, raise a number of regulatory issues, including questions of accountability. Custodians of such pools, usually banks, often do not provide daily statistics on the composition of such pools that enable the mutual funds to determine the composition of their portfolios and mark their investments to market on a daily basis. The SEC staff believes that such information must be obtained daily to properly value a fund's portfolio.

Small Business Administration

.18 The Small Business Administration (SBA) issued a final rule on auditing standards to be used in the conduct of audits of financial statements of Small Business Investment Companies (SBICs), which are filed with the SBA. The rule, which is effective September 7, 1993, for fiscal years ending after December 31, 1992, states that SBIC audits should continue to be performed in accordance with GAAS. The SBA rule also requires auditors to report irregularities, illegal acts, and reportable conditions to management *in writing* and calls upon auditors to report the noted instances to the SBA if management fails to do so. These reporting responsibilities exceed those set forth in GAAS and are inconsistent with the auditor's detection responsibility under GAAS for errors and irregularities that are material to the financial statements and illegal acts that may have a direct and material effect on the determination of financial statement amounts.

Internal Revenue Service

.19 The Internal Revenue Code of 1986, as amended, provides that mutual funds qualifying as regulated investment companies (RICs) are not liable for federal income taxes as long as they comply with rules set forth in Subchapter M of the Code. It is important that the auditors consider whether mutual funds have complied with those regulations, which set forth criteria for minimum distribution requirements to avoid federal income and excise tax liabilities. Failure to record a liability for federal income taxes when necessary could have a direct and material effect on the financial statements of an investment company. Chapter 4 of the Audit and Accounting Guide *Audits of Investment Companies* describes the amended Code's effect on RICs.

.20 The daily sales and purchases of shares in, and frequent cash distributions made by, mutual funds subject them to numerous Internal Revenue Service (IRS) reporting regulations that relate more to their operational aspects than to their financial and accounting aspects. For example, failure to properly file information returns, such as Form 1099DIV reporting dividends to shareholders, with the IRS can result in substantial penalties. Accordingly, auditors should be alert to such illegal acts.

Audit Issues and Developments

Audit Issues

.21 *Derivatives and Other High-Risk Investments.* Recent years have seen a growing use of innovative financial instruments that often are very complex and can involve a substantial risk of loss. Users and issuers of such instruments must have the expertise necessary to understand and manage the related risks. As discussed below, auditors should also be familiar with such instruments and the associated risks. One class of these instruments—derivatives—requires particular attention.

.22 Derivatives are complex financial instruments whose values depend on the values of one or more underlying assets or financial indexes. Derivatives generally fall into at least two categories:

1. Mortgage-backed securities, which include interest-only and principal-only strips, and tranches of collateralized mortgage obligations
2. Off-balance-sheet instruments such as commodity and financial futures contracts, forward placement commitment contracts, standby commitments, put and call options, and repurchase agreements

.23 Increased volatility of interest rates, foreign exchange rates, and commodity and other prices has also fostered tremendous innovation in financial products to meet the needs of users attempting to hedge or alter the related risks. By reconfiguring cash flows associated with underlying assets, an issuer can create asset-backed securities that meet the needs of and are attractive to various potential users by isolating, enhancing, or diluting one or more of credit, liquidity, interest rate, and other risks inherent in the underlying cash flows. For example, through mortgage-backed securities, the issuer can enhance the marketability of underlying mortgage loans by spreading liquidity and credit risk across broad pools, or by providing a higher yield to those users willing to accept a higher concentration of the risks associated with specific collateral cash flows. Similarly, users find certain derivatives attractive because they can purchase the risks and rewards they desire most, or can synthetically create a security with the desired risk and reward characteristics.

.24 *Accounting*—Accounting for derivatives is complex. The AICPA Audit and Accounting Guide *Audits of Investment Companies* includes a discussion of accounting for specific types of securities, including a number of derivatives. However, given the constant innovation and complexity of derivatives, accounting literature does not explicitly cover some derivatives, however, several related projects are underway.

.25 The Financial Accounting Standards Board (FASB) has been carrying out a major project on the recognition and measurement of financial instruments, which has already resulted in the issuance of FASB Statements of Financial Accounting Standards No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (AC F25), and No. 107, *Disclosures about the Fair Values of Financial Instruments* (AC F25), and FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts* (AC B10), that address related issues. The FASB's project includes a comprehensive review of accounting for hedging and risk-adjusting derivatives. Also, the International Accounting Standards Committee is in the process of developing an international accounting standard for financial instruments.

.26 Several accounting issues involving derivatives have also been addressed by the FASB's Emerging Issues Task Force (EITF). Other guidance that may be useful to investment companies in determining how to account for derivatives is provided by FASB Statements No. 52, *Foreign Currency Translation* (AC F60), and No. 80, *Accounting for Futures Contracts* (AC F80). In addition, the AICPA Issues Paper No. 86-2, *Accounting for Options,* discusses various matters related to options.

.27 *Auditing*—The innovative and complex nature of such investment vehicles may significantly increase audit risk. For example, the fair value of derivatives can be volatile in periods of changing market conditions. Furthermore, as more and more financial institutions enter the markets for such instruments, their profitability may diminish. Traders may attempt to compensate for the diminution by increasing the volume of transactions involving such instruments or by further customizing products. An increase in volume may be accompanied by trading with counterparties that have higher credit risk. Customizing transactions may increase valuation difficulties. The propriety of the methods used by the managements of investment companies to account for transactions involving sophisticated financial instruments and to determine their value should be carefully considered. Understanding the substance of transactions in such instruments is important in determining the propriety of their accounting treatment. In some circumstances, auditors may find it helpful to consult with experts.

.28 SAS No. 22 (AU section 311) requires that auditors understand the events, transactions, and practices that, in their judgment, may have a significant effect on the financial statements. Accordingly, auditors should carefully consider the various risks involved with investments in derivatives and other complex securities as they plan their audits and should—

1. Assess management's expertise in monitoring, evaluating, and accounting for the securities.
2. Ensure that the entity has set appropriate policies and procedures for investment in high-risk securities and that there is adequate oversight by the board of directors.
3. Involve specialists, when necessary, in valuing and auditing these investments.

.29 *Service-Center-Produced Records.* Investment companies frequently operate in an environment in which service organizations functioning as service agents, fund custodians, transfer agents and in other administrative capacities play a critical role in the accounting function. In assessing control risk in such an environment, auditors must carefully consider the functions or processing of information performed by the service organizations. SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AU section 324), which was issued in April 1992 and supersedes SAS No. 44, *Special-Purpose Reports on Internal Accounting Control at Service Organizations,* provides guidance to auditors performing audits of investment companies that use such organizations.

.30 When an investment company uses a service organization, the functions or processing performed by the service organization may have a significant effect on the investment company's financial statements. Because the processing may be subjected to control policies and procedures that are physically and operationally separate from the investment company, the internal control structure of the investment company may include a component that is not directly under the control and monitoring of its management. SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AU section 319), requires an auditor to obtain a sufficient understanding of an entity's internal control structure to plan an audit. For this reason, planning the audit of an investment company may require that the auditor gain an understanding of the control policies and procedures performed by service organizations. When an investment company relies on a service organization's control policies and procedures over the processing of transactions that are material to the investment company's financial statements, those control procedures should be considered by the auditor. One method of obtaining information about those policies and procedures is to obtain a service auditor's report as described in SAS No. 70 (AU section 324).

.31 Auditors frequently inquire whether it is necessary to obtain a service auditor's report when their clients use service organizations. The fact that an entity uses such an organization does not, in itself, require that such a report must be obtained. In certain situations, the investment company may implement control policies and procedures that will obviate the need for a service auditor's report. For example, an investment company using a payroll service may routinely compare the data submitted to the service organization with reports received from the service organization to check the completeness and accuracy of the data processed. The investment company may also recompute a sample of the payroll checks for clerical accuracy and review the total payroll for reasonableness. In such circumstances, the investment company is not relying on the service organization's controls.

.32 Other factors that may be considered in determining whether to obtain a service auditor's report are—

- Whether the transactions or accounts affected by the service organization are material to the investment company's financial statements.
- The extent to which the user organization retains responsibility for authorizing the transactions and maintaining the related accountability.
- The availability of other information (for example, user manuals, system overviews and technical manuals) at the investment company that may provide the auditor with sufficient information to plan the audit.

The AICPA's Auditing Standards Division expects to issue an Auditing Procedure Study, *Implementing SAS No. 70, Reports on the Processing of Transactions by Service Organizations,* early in 1994.

.33 *Valuation of Securities.* Investments generally represent the most significant asset in an investment company's statement of assets and liabilities. Additionally, the daily purchase and redemption prices of fund shares are based almost exclusively on the value of a fund's investment portfolio. For these reasons, the valuation of the investment securities is a prime concern for auditors of investment companies.

.34 Increased competition among mutual funds has heightened pressure on fund managers to improve financial returns and has resulted, in some instances, in more aggressive investment strategies. Those strategies may include investing in more complex and higher-risk securities, the values of which may not be readily available through market quotation. Such securities are often valued at amounts determined by the board of directors. Auditing the valuation of such securities is an area that requires a high degree of judgment and additional scrutiny to ensure that the carrying values approximate fair value. Chapter 2 of the Audit and Accounting Guide *Audits of Investment Companies* describes the estimation of fair values of securities in good faith by boards of directors. In auditing securities valuations determined by the board of directors, auditors should review the information considered by the board in determining the value of the securities, ascertain that the procedures followed were reasonable, and read relevant minutes. In some instances, auditors may consider using the work of a specialist in auditing the valuation of such securities.

.35 The Audit and Accounting Guide *Audits of Investment Companies* and SOPs 93-1, *Financial Accounting and Reporting for High-Yield Debt Securities by Investment Companies* (No. 014876), and 93-4, *Foreign Currency Accounting and Financial Statement Presentation for Investment Companies* (No. 014874), include further guidance on testing portfolio valuations, including estimates of values determined in good faith by boards of directors. SOP 93-1 is effective for fiscal years ending after December 15, 1993, and interim periods within such years. SOP 93-4 is not required to be applied to audits for years ending before December 15, 1994, but its early adoption is encouraged.

.36 *Multiple Class Funds.* Multiple class funds are those that issue more than one class of shares. The multiple class structure raises a number of regulatory, tax, operational, accounting, and financial reporting issues, many of which relate to allocations of income, expenses, and distributions among the different classes of shares. Certain of those issues affect the initial organization of the fund while others may require auditors' continuing attention.

.37 The SEC staff has expressed its belief that such allocations should be based on relative net asset values among share classes, except for funds for which net asset value remains at a constant dollar amount (such as money market funds), where allocations based on relative numbers of shares is acceptable.

.38 In obtaining the understanding of the internal control structure required by SAS No. 55 (AU section 319), auditors should consider whether management has implemented procedures for allocating fund income, expenses, realized and unrealized gains, and distributions to the multiple classes of shares.

.39 Before approving multiple class arrangements, the SEC staff requires a letter from an independent expert, generally the fund's independent auditor, reporting on the initial design of the internal control structure relative to allocating earnings, determining dividends, and calculating net asset value per share. A report on the design and testing of that internal control structure (as described in SAS No. 70 [AU section 324]) is required annually.

.40 *Master/Feeder Funds.* Master/feeder funds, also known as hub and spoke funds, permit a number of funds (feeders) with similar investment objectives to invest in a single entity (master). This structure is intended to enable smaller funds to achieve economies of scale while the limited partnership master hub passes through to the feeder the character of income generated. The SEC staff currently requires financial statements of the master to be filed with each publicly held feeder's financial statements.

Audit Developments

.41 *Reporting on Internal Control.* In May 1993, the AICPA Auditing Standards Board issued Statement on Standards for Attestation Engagements (SSAE) No. 2, *Reporting on an Entity's Internal Control Structure Over Financial Reporting* (AT section 400), which is effective for examinations of the effectiveness of an entity's internal control structure over financial reporting when the entity's assertion is as of December 15, 1993, or thereafter. SSAE No. 2 (AT section 400) provides guidance to accountants who are engaged to examine and report on management's written assertions about the effectiveness of an entity's internal control structure over financial reporting as of a certain point in time. The Statement does *not* change the auditor's responsibility to consider the entity's internal control structure over financial reporting in an audit of financial statements.

.42 Form N-SAR requires a report on the internal control structure of an investment company. Reports prepared to meet the requirements of Form N-SAR are *exempted* from the scope of SSAE No. 2 (AT section 400). The Audit and Accounting Guide *Audits of Investment Companies* includes an illustration of a report that meets the requirements of Form N-SAR.

.43 *Attesting to Investment Presentations.* The AICPA's Auditing Standards Division has issued a Notice to Practitioners, *Engagements to Report on Performance Presentation Standards of the Association for Investment Management and Research.* The Notice provides guidance to practitioners who are engaged to attest to presentations of performance information in conformity with Performance Presentation Standards established by the Association for Investment Management and Research (AIMR). The Notice explains how SSAE No. 1, *Codification of Statements on Standards for Attestation Engagements* (AT section 100), applies to such engagements and provides specific performance and reporting guidance (including illustrative attestation reports). Copies of the Notice can be obtained by calling the Auditing Standards Division at 212-596-6036. Copies of the AIMR Performance Presentation Standards can be obtained from the AIMR, 5 Boar's Head Lane, Charlottesville, Virginia 22903 (Phone 804-977-6600; Fax 804-977-1103).

Accounting Developments

AICPA Statements of Position

.44 The AICPA's Accounting Standards Executive Committee (AcSEC) has issued the following SOPs, all of which amend the Audit and Accounting Guide *Audits of Investment Companies.*

.45 SOP 93-1 provides guidance for financial reporting of junk bonds and other debt securities held as investments and recommends procedures to be considered by auditors for reviewing valuations of such securities. Auditors should consider whether the provisions of the SOP are being appropriately applied and whether the audit procedures suggested in the SOP should be performed.

.46 SOP 93-2, *Determination, Disclosure, and Financial Statement Presentation of Income, Capital Gain, and Return of Capital Distributions by Investment Companies* (No. 014877), which is effective for fiscal years ending after December 15, 1993, and interim periods within such years, provides guidance on financial reporting for distributions to shareholders, including returns of capital. Although this SOP recognizes that financial statements of investment companies are prepared on the basis of generally accepted accounting principles, it recommends that, to avoid shareholder confusion, the term *tax return of capital* be used to report portions of shareholders' distributions that are in excess of tax-basis current and accumulated earnings and profits. The auditors should consider whether the provisions of the SOP are being appropriately applied.

.47 SOP 93-4 requires reporting of all foreign currency transaction gains and losses other than those related to investments, and provides guidance on the calculation and reporting of realized and unrealized foreign currency gains and losses in financial statements. This SOP does not require separate reporting of the portion of the realized gains and losses on investments and the changes in market values of investments that result from changes in foreign currency rates. However, it does provide guidance on the manner in which such unrealized and realized gains and losses should be measured and reported if separate reporting is adopted. Although this SOP is not required to be applied to financial statements for fiscal years ending before December 15, 1994, its earlier application is encouraged. The auditors of an entity that adopts the SOP before then needs to consider whether the SOP's guidance on calculating realized and unrealized gains and losses has been appropriately implemented when addressing audit assertions dealing with valuation and whether the reporting guidance has been implemented as he or she considers assertions relating to presentation and disclosure.

Other AICPA Activities

.48 An exposure draft was issued on September 15, 1993, for a proposed SOP, *Financial Reporting for Investment Partnerships,* which would amend the Audit and Accounting Guide *Audits of Investment Companies* to require investment partnerships to—

1. Include a list of investments in securities, as illustrated in the Guide.
2. Present a statement of operations as illustrated in the Guide.
3. Account for performance fees in accordance with partnership agreements and disclose how such fees are computed.

.49 *Accounting for Distribution Fees.* The Investment Companies Committee is drafting a proposed SOP on accounting by investment companies for distribution fees under enhanced 12b-1 plans. An exposure draft of the proposed SOP is expected to be issued in the first quarter of 1994.

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.50 This Audit Risk Alert replaces *Investment Companies Industry Developments—1992.*

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.51 Auditors should also be aware of the economic, regulatory, and professional developments that may affect the audits they perform, as described in *Audit Risk Alert—1993* [AAM section 8010].

[The next page is 8343.]

AAM Section 8160

Oil and Gas Producers Industry Developments—1993

Industry and Economic Developments

.01 Many factors will affect crude oil and natural gas markets in both the short and long term. Supply-side factors include the extent to which the Organization of Petroleum Exporting Countries (OPEC) produces and exports crude oil and the potential reversal of the present decline in the production and exportation of crude oil by the Commonwealth of Independent States (CIS), particularly Russia. Also, increased exploration and development in various Latin American countries could lead to significant increases in supply from that part of the world. The principal demand-side factor that will affect energy markets will be the rate of economic growth, but environmental factors will increasingly affect the level and composition of demand. Environmental factors will also affect oil supplies.

.02 The greatest uncertainties in the short term concern OPEC production, economic growth rates, and weather patterns. OPEC (composed of twelve oil-producing countries primarily in the Middle East) announced in September that its members had agreed to individual quotas to limit production through February 1994 to 24.5 million barrels a day. Kuwait and Iran scored significant increases in their individual share of OPEC's overall output, whereas Saudi Arabia, the world's largest producer and exporter of oil, agreed to freeze its production at current levels until April 1994. The agreement is an attempt to limit production and increase the price of oil, which has fallen by 20 percent since early summer. Announcement of the new agreement sent oil prices immediately higher, with an expected additional price rise of three to four dollars a barrel.

.03 The oil and gas industry's worldwide investment needs through the end of the 1990s are large. Hundreds of billions of investment dollars will be required just for exploration and development if the expected increase in demand for oil and gas is to be met even at higher real prices. The development of alternative sources of energy is expected to have little effect on the prices of oil and gas.

.04 The foreign share of the U.S. petroleum industry's worldwide exploration and development expenditures is increasing as the opportunity for significant new domestic finds decreases and as the terms for production-sharing agreements in many foreign countries continue to improve. Recently, the share of U.S.-based major petroleum companies' exploration and development expenditures allocated to foreign locales was about 50 percent. This was considerably above the 27-percent share of the mid-1980s. The amount allocated accounted for more than three-quarters of the foreign spending on all businesses by those major companies.

.05 The North Sea has for years been a major target for exploration and development expenditures by U.S. firms. However, investment opportunities are emerging rapidly in other areas of the world and could compensate for any slowdown in investment in the North Sea and more mature areas. These other areas include the CIS, Latin America, and Southeast Asia. The largest finds in Southeast Asia have been offshore.

.06 Development of reserves in the CIS, particularly in Russia, is highly dependent on Western investment. Expectations are that the ongoing decline in oil and gas production in Russia could reverse by the middle of the 1990s if adequate investment is forthcoming. An increasing number of U.S. firms are exploring such opportunities. Most activity is in the form of joint ventures. Participation by U.S. companies in crude oil and natural gas production in Latin America has not changed substantially in recent years despite some large finds of new reserves. Some of Latin America's largest producing countries, particularly Mexico, Venezuela, and Brazil, retain strong restrictions on direct foreign investment in petroleum.

.07 Southeast Asia is rapidly becoming a prime target for oil and gas investment by U.S. and foreign firms. Governments in the subcontinent are actively seeking foreign investment through the production stage. U.S. companies' exploration and development spending (excluding property acquisition) has grown at a more rapid rate in Southeast Asia since the mid-1980s than in any other foreign area. Foreign crude oil production data have shown a similar pattern.

.08 The prospective increases in exploration and development spending by indigenous and foreign sources in the non-OPEC world outside North America will likely result in some increase in productive capacity. Capacity in North America, on the other hand, could decline. Non-OPEC production will likely decline during the next few years, but mainly because of a continued downturn in U.S. and CIS production during that period.

Regulatory Developments

Environmental Developments

.09 Environmental developments could significantly affect crude oil and natural gas production and use both domestically and abroad, for years to come. Shifts in fuel choice and energy use have occurred in the past, but largely not for environmentally related reasons. The crude oil price increases of 1973 and 1979, for example, caused demand to decrease.

.10 Recently enacted legislation, such as the Oil Pollution Liability and Compensation Act of 1990 (the Act) and the Clean Air Act Amendments of 1990, deal directly with energy-related environmental problems in the United States. The principle behind such legislation is that, without government intervention, the prices of some energy products will not reflect the costs of environmental damage associated with their use. Government actions such as taxes, restrictions, and prohibitions are intended to compensate for or prevent environmental harm and thereby "internalize" the costs of compensation or prevention into the prices paid by energy consumers. Among other things, higher prices due to internalized environmental costs increase the economic incentives to use cleaner, often renewable, fuels. The imposition of environmental standards through government regulation, although it involves little or no outlay of money by the government, can lead to very substantial increases in the cost of energy products.

.11 Many of the new laws and regulations will affect the crude petroleum and natural gas industry. But the effects will usually be indirect because most of the new requirements will be imposed on vehicles, refineries, petroleum products, ships, and pipelines, as well as on the amount of pollutants, rather than directly on crude oil and natural gas producers. For example, the Act imposes specific federal liabilities on tankers and on offshore and onshore facilities for oil spill cleanup and damage repair, and allows states to independently impose other forms of liability. It requires double hulls for all new tankers and for all vessels trading with the United States. Most single-hulled tankers and barges will be phased out over a fifteen-year period. The Act also establishes a $1 billion federal oil spill cleanup fund, using an existing fee of 5 cents per barrel on oil. The Act substantially increases the potential penalties against tanker owners in case of an oil spill. Regulations implementing the Act are currently being developed by the U.S. Coast Guard. The Clean Air Act Amendments of 1990 include more stringent emission standards for most offshore drilling activities. This Act also creates special programs for California vehicles, urban buses, and private and government-owned fleet vehicles that encourage, and in some cases mandate, the use of alternatives to gasoline and diesel fuel. This will likely be favorable to producers of natural gas.

.12 The Securities and Exchange Commission's (SEC's) Staff Accounting Bulletin (SAB) No. 92, *Accounting and Disclosures Relating to Loss Contingencies*, addresses issues related to loss contingencies, focusing primarily on environmental and product liability contingencies. SAB No. 92 provides an interpretation of current accounting literature related to offsetting probable recoveries against probable contingent liabilities; recognition of liability for costs apportioned to other potential responsible parties; uncertainties in estimation of the extent of environmental or product liability; the appropriate discount rate for environmental or product liabilities, if discounting is appropriate; accounting for exit costs; necessary financial statement disclosures; other disclosures outside the financial statements; and other issues.

.13 SAB No. 92 addresses accounting and disclosure for site restoration or other environmental exit costs. Although industry practices with respect to exit costs may differ, an SEC registrant must disclose its accounting policy for such costs pursuant to Accounting Principles Board (APB) Opinion No. 22, *Disclosure of Accounting Policies* (AC A10). For material exit-cost liabilities, disclosures should include the nature of the costs involved, the total anticipated cost, the total costs accrued to date, the balance sheet classification of accrued amounts, the range or amount of reasonably possible additional losses, and other related disclosures required by SAB No. 92. SAB No. 92 also indicates that entities may accrue the exit costs over the useful life of an asset. Auditors should also follow the guidance in the Financial Accounting Standards Board's (FASB's) Emerging Issues Task Force (EITF) Issue No. 93-5, *Accounting for Environmental Liabilities. Audit Risk Alert—1993* [AAM section 8010] includes a more detailed discussion of accounting and auditing issues related to such costs.

Minerals Management Service

.14 The Department of the Interior's Minerals Management Service (MMS) has always required, in its product valuation regulations, that royalties be paid on a value that cannot be less than the "gross proceeds" accruing to the lessee for the disposition of minerals produced from federal or American Indian leases. During the past several years, many lessees have entered into agreements with purchasers settling various issues pertaining to the sale of production from federal and American Indian leases that have arisen under their contracts. These settlements frequently involve a lump-sum payment by the purchaser, who is to be relieved of some or all of its obligations under the sales contract. MMS has issued a Royalty Management Program (RMP) interpretation of how the various gross proceeds regulations apply to amounts received under such contract settlements. The RMP interpretation clarifies that lessees and other debtors are required to pay royalties on contract settlement payments to the extent that payments are attributable to minerals produced from the lease. Under this interpretation, some or all of a settlement may become royalty-bearing if production to which specific money is attributable occurs.

.15 The MMS expects to collect $200 to $300 million over the next four to five years in royalties owed on these settlements. The agency is reviewing contract buyouts and contract buy-downs that took place after natural gas prices plummeted. The agency has reviewed each of the following types of settlement and has issued the following conclusions:

1. Take-or-pay issues are not royalty-bearing.
2. Pure contract terminations are not royalty-bearing.
3. Past pricing disputes are not presumed to be royalty-bearing.
4. Recouped take-or-pay is presumed to be royalty-bearing.
5. At least some portion of a buy-down is considered to be royalty-bearing.
6. Contract terminations for which no production is attributable are considered not to be royalty-bearing.

Auditors of oil and gas producers involved in these types of transactions should be aware of the above conclusions. These contracts may need to be reviewed individually by the auditor, as most contracts differ and the issues are extremely complex. The auditor may wish to consider the use of a specialist in this area; if so, the auditor should follow the guidance of AICPA Statement on Auditing Standards (SAS) No. 11, *Using the Work of a Specialist* (AU section 336).

Other Regulatory Developments

.16 Two regulations of particular relevance to the natural gas industry relate to wellhead price controls and to pipelines.

.17 The wellhead price of natural gas was entirely deregulated as of January 1993, in the third and final phase of deregulation legislation passed in 1989. The market impact of this final stage of deregulation is estimated to be small since most gas produced was already free of wellhead price control.

.18 The second regulatory change relates to pipelines and their relationship to suppliers of natural gas. Effective May 18, 1992, the Federal Energy Regulatory Commission (FERC) changed its regulations to enhance the competition among natural gas suppliers. The basic purpose of the changes (FERC Order 636) is to eliminate the competitive advantage of gas pipeline companies over other sellers of natural gas. The advantages at issue are based upon a pipeline company's ability to "bundle" gas, its transportation, and other related services into a composite commodity. Given this, a pipeline's operating practices may have tended to favor the transportation of its own product to the disadvantage of gas provided by other sellers but also transported by the pipeline.

.19 The point of the regulatory changes is to ensure that the transportation services provided by the pipeline are the same for all gas suppliers. This should maximize the number of sellers that a buyer could reach when purchasing a service of a given quality. Generally, this should enable buyers to pay the lowest available price and sellers to receive the highest available price.

Audit Issues

Overall Risk Factors

.20 Although conditions vary from company to company, the following are among the concerns specific to the oil and gas producing industry:

- OPEC politics
- Volatility in crude oil prices and the demand for natural gas
- Level of interest rates
- Changes in the U.S. tax laws
- Changes in capital and credit market perceptions
- Changing prices and demand affecting the value of oil and gas reserves used as collateral for loans

Auditors should consider the above in assessing inherent risk in the audit of an oil and gas producer. Auditors should also consider the following factors (paragraphs .21 through .30), any of which may indicate an increased audit risk for an oil and gas producer.

.21 *Liquidity and Financial Resources.* Auditors should consider the availability of adequate cash flow from internal and external sources, the impact on cash flow of revised timing and pricing of oil and gas production, the ability to meet fixed commitments and debt service requirements, and the implications of evidence that may bring into question the entity's continued existence as a going concern.

.22 *Asset Realization.* Auditors should address the collectibility of joint interest receivables, the possible impairment of undeveloped properties resulting from declining leasehold values and the entity's inability to carry and develop properties, the potential impairment of producing properties as a result of the reduced value of the related reserves, and whether lease and well equipment inventory should be written down because of excess supply.

.23 *Product Marketability.* Production of gas wells may be suspended because of excess supply or uncertainty about gas pricing. Auditors should ensure that nonproducing gas wells have been identified and should become aware of significant gas contract provisions and consider their potential impact on the financial statements.

.24 *Joint Interest Operations.* Joint ownership increases the likelihood of exposure to financially distressed operators. The auditor of a nonoperator may wish to consider the extent and findings of joint interest audits, the adequacy of the operator's internal control structure, any conflicts of interest or related-party transactions involving the operator, and the operator's ability to meet its financial and operating commitments. Auditors may also consider whether the operator is using funds and properties in accordance with agreements and whether the nonoperator has legal and unencumbered ownership of properties and production revenues.

.25 *Reliability of Reserve Estimates.* The reliability of reserve estimates depends primarily on the use of reputable and qualified petroleum engineers and on the availability, nature, completeness, and accuracy of the data needed to develop the reserve estimates. The reliability of reserve estimates has a direct impact on the calculation of depreciation, depletion, and amortization, as well as on ceiling or impairment tests.

.26 *Debt Compliance.* Complying with debt covenants may be difficult for some oil and gas companies in an uncertain economic environment. Technical defaults require written waivers and close review by auditors. Auditors should refer to *Audit Risk Alert—1993* [AAM section 8010] for a more detailed discussion of debt compliance.

.27 *Variety and Complexity of Agreements.* The extensive use of innovative financing methods involving complex sharing and commitment terms that require accounting recognition or disclosure is common in the industry. Complying with the specific terms of partnership, joint venture, and operating agreements may be difficult. Contract terms otherwise regarded as inconsequential (for example, dissolution, buyouts, and additional financing commitments) take on increased importance for both the company and its auditor in an economic downturn. The auditor may wish to consider the use of a legal expert, under which circumstances the auditor should follow the guidance of SAS No. 11 (AU section 336).

.28 *Complex Income Tax Considerations.* Income tax provisions, proved reserve quantities, and the standardized measure may be affected by income tax deductions and tax credits peculiar to the oil and gas and similar industries. Examples of tax matters unique to these industries are percentage depletion, tax credits for nonconventional fuel production, and tax credits for enhanced oil recovery. Virtually every oil and gas company is faced with a variety of transactions that either must or may be treated differently for tax purposes than for financial reporting purposes. Furthermore, most independent oil and gas producers pay the alternative minimum tax rather than the regular federal income tax, making the current expense portion of the income tax computation particularly complex. Auditors should have an understanding of the income tax considerations affecting the financial statements of oil and gas producers.

.29 *Hedging.* Some oil and gas producers from time to time hedge or speculate with energy futures or options on such futures. Normally, subsequent production, rather than existing inventory, is hedged.

.30 *Related-Party Transactions.* Related-party transactions are often extensive; they may result in possible conflicts of interest among investors, operators, and general partners.

Audit Developments

Asset Ownership and Valuation

.31 Two areas of increased risk for auditors of oil and gas producers are management's assertions of ownership and valuation of assets. Valuation problems may arise from failure to apply SAB Topic 20, *Financial Statements of Oil and Gas Exchange Offers*, which, in some circumstances, requires that assets acquired from promoters or shareholders be recorded at the transferor's historical cost basis.

Innovative Financing Arrangements

.32 Over the past several years, there has been a slow deterioration in the domestic oil and gas industry and a move toward international expansion. Much of the international expansion is being funded through a redirection of operating cash flows away from domestic programs and into international programs. The more traditional flows of investment capital in the industry through direct investments, partnerships, and joint ventures with industry partners have all but disappeared. Many companies that are already highly leveraged are forced to seek other sources of cash flows to fund domestic and foreign operations. Since current sources of external capital funding are generally tight, much of the capital flowing into the industry is being supplied by insurance companies, international money banks, pension funds and foreign investors. Because of various tax considerations and concern over high balance-sheet debt levels, and to meet the objectives of other corporate strategies, many innovative transactions are being considered as means of attracting capital. The accounting for such transactions may not be covered by or addressed specifically in existing authoritative literature. These transactions may involve off-balance-sheet financing, special-purpose entities, and related questions about consolidation policies. Auditors should carefully evaluate such transactions as they assess the propriety of the accounting treatment of and financial statement disclosures related to them.

Estimated Reserves

.33 As discussed earlier, the reliability of reserve estimates is a key consideration in many aspects of accounting for oil and gas producing activities. Reserve estimates have a direct impact on the calculation of depreciation, depletion, and amortization as well as on ceiling and impairment tests. In addition, some companies with bank debt and other forms of long-term borrowing may be subject to various debt covenants that are based on the value of oil and gas reserves. Such covenants may stipulate, for example, that if the value of the reserves falls below a certain level, the entire debt, or a part thereof, may be callable in the current year. Auditors should review debt covenants for such matters and consider the effect of reserve valuations and debt restrictions. Auditors should be alert to matters subject to "events of default" and, if necessary, examine written waivers from lending institutions. See *Audit Risk Alert—1993* [AAM section 8010] for a more detailed discussion of debt covenants.

.34 In assessing the reliability of reserve estimates, auditors should consider whether qualified and reputable petroleum engineers have been involved in determining reserve estimates and should evaluate the nature, completeness, and accuracy of the data used to develop the reserve estimates. If engineers were involved in the determination of the reserve estimates, the auditor should follow the guidance of AICPA SAS No. 11's Auditing Interpretation No. 1, "Applicability of Guidance on the Use of Specialists" (AU section 9336.01-.03).

.35 FASB Statement of Financial Accounting Standards No. 69, *Disclosures About Oil and Gas Producing Activities* (AC Oi5), sets forth requirements for a comprehensive set of disclosures for oil and gas producing activities. The Statement also requires publicly traded enterprises with significant oil and gas producing activities to disclose prescribed supplementary information that includes data about their reserves. SAS No. 52, *Omnibus Statement on Auditing Standards—1987* (AU section 558), provides guidance to auditors regarding the procedures they should apply to required supplementary information and describes circumstances that require reporting on such information.

New Cost Centers

.36 Many domestic oil and gas exploration and production companies using the full-cost method of accounting are involved in exploratory activities in foreign locations (new cost centers). In such circumstances, auditors should carefully evaluate the propriety of deferring costs for new cost centers when the outcome of a field, or concession as a whole, has not been determined. Auditors of publicly held registrants should note that rule 4-10 (i)(3)(ii)(A) of SEC Regulation S-X states that any dry hole costs incurred should "be included in the amortization base immediately upon determination that the well is dry." Auditors should consider reviewing analyses of costs being deferred as well as the results of the exploration activities in assessing the propriety of costs deferred. If results are favorable, an extended deferral may be appropriate; however, if results are unfavorable, continued deferral of the cost may not be justifiable.

Accounting Issues

Joint Ventures—Accounting by the Investor

.37 By establishing joint ventures (JVs) with one or more other oil and gas producers, a producer may be able to extend its exploration and development in new geographic areas. Some of the accounting issues associated with JVs are discussed below.

.38 *Evaluation of Control.* In evaluating whether a JV needs to be consolidated, an agreement between the venturers that requires the consent of both venture parties for typical corporate actions generally indicates neither venturer has control. For example, if a majority holder cannot order the sale of assets in the ordinary course of business without the consent of its JV partner, the majority owner generally does not have control. However, if the JV agreement requires the consent of both parties only in the case of a disposition of *substantially all* assets, an action that is clearly not in the ordinary course of business, the SEC staff has informally concluded that this provision would not negate other aspects of control. The following are some examples of evaluating the control situation:

- In one situation, the majority owner did not have the unilateral ability to buy, sell, or pledge assets without the consent of its JV partner if the transaction exceeded 5 percent of the JV asset base. In this case, control was not present.
- In another situation, a 50 percent owner (1) had the tie-breaking vote with respect to operating and financial policies of the JV, (2) had the ability to acquire and dispose of assets in the ordinary course of business, and (3) could dispose of up to 95 percent of JV assets without the consent of the JV partner. In this case, the 50 percent owner had control.

.39 *Contributions of Assets.* As a general rule, the contributions of assets to a JV should not result in gain recognition. However, when cash is received by the investor without any commitment for reinvestment, gain recognition may be considered acceptable. Under EITF Issue No. 89-7, *Exchange of Assets or Interest in a Subsidiary for a Noncontrolling Equity Interest in a New Entity,* such gain should not be recognized if the enterprise has an actual or implied commitment, financial or otherwise, to support the operations of the new entity. The SEC has emphasized that any gain recognition is heavily dependent on a careful analysis of specific facts and circumstances. Gain recognition would not be appropriate if a significant uncertainty exists regarding realization or the enterprise has an actual or implied commitment to support the operations of the new entity in any manner.

.40 Gains may also be recognized to the extent that other *near cash,* such as monetary assets or traded marketable securities, are part of the exchange.

Interests Conveyed

.41 Net profit interests or overriding royalty interests in proved reserves that are conveyed to employees and to lenders should be accounted for as conveyances based on the fair value of the interests conveyed. Auditors of oil and gas producers with such conveyances to employees should consider whether these interests are appropriately treated as compensation expense to the producers. Auditors of oil and gas producers with such conveyances to lenders should consider whether these interests are appropriately treated as debt discounts.

Capitalized Costs

.42 In accordance with APB Opinion No. 22, *Disclosure of Accounting Policies* (AC A10), the accounting policy for capitalizing internal costs, such as salaries and all related fringe benefits paid to employees directly engaged in the acquisition, exploration, and development of oil and gas properties, as well as all other directly identifiable general and administrative costs associated with such activities, such as rentals, utilities, and insurance, should be disclosed. Such disclosure should be made regardless of whether the producer uses the full-cost or successful-efforts method of accounting. Also, the amount of such capitalized general and administrative costs should be included in the disclosures of property acquisition, exploration, and development costs required by paragraph 21 of FASB Statement No. 69 (AC Oi5.171) for each period presented.

Accounting Developments

Impairment of Oil and Gas Properties

.43 Issues regarding the impairment of long-lived assets have surfaced with increasing frequency in recent years. Because of the long-term and uncertain nature of oil and gas exploration and production activities, such issues are especially relevant to entities with oil and gas producing activities.

.44 SEC Regulation S-X requires that capitalized costs by publicly held companies following the full-cost method be subjected to a "ceiling test." The rule, rule 4-10(i)(4) of Regulation S-X, requires that for each cost center, capitalized costs, less accumulated amortization and related deferred income taxes, shall not exceed an amount (the cost center ceiling) equal to the sum of (1) the present value of estimated reserves computed by applying prices of oil and gas reserves to estimated future production, less estimated future expenditures and a discount factor of 10 percent; plus (2) the cost of properties not being amortized pursuant to paragraph (c)(3)(i) of rule 4-10(i)(4); plus (3) the lower of cost or estimated fair value of unproven properties included in the costs being amortized; less (4) income tax effects related to differences between the book and tax basis of the properties.

.45 The SEC staff has indicated that for entities using the successful-efforts method of accounting for oil and gas properties, total capitalized costs, as a minimum test, may not exceed future undiscounted after-tax net revenues on a world-wide basis. Due to variations in the method for testing impairment for companies using the successful-efforts method of accounting, the SEC staff has been requesting that registrants disclose their method for testing impairment.

.46 The SEC staff also indicated a position that the ceiling test should be applied using current prices at interim periods as well as at year end. The SEC staff has objected when registrants have used estimated annual prices in applying interim period ceiling tests because of the subjective nature of the process employed in estimating such prices.

.47 Auditors should review the components of the cost-ceiling computation to determine whether they are in accordance with prescribed guidelines.

Hedging of Oil and Gas Production

.48 From time to time, oil and gas producers hedge or speculate by entering into energy futures contracts or options. In order for futures contracts to qualify as hedges, they must meet the conditions set forth in FASB Statement No. 80, *Accounting for Futures Contracts* (AC F80). The conditions that must be met are (1) the item to be hedged exposes the enterprise to price or interest rate risk, and (2) the futures contract reduces that risk and is designated as a hedge. However, certain futures contracts (for example, natural gas futures traded on the New York Mercantile Exchange) do not always track price movements of natural gas delivered in certain regions of the country, especially during certain seasons or at certain points during the life of futures contracts. Auditors should consider whether management's designation of futures contracts as hedges is appropriate in light of the criteria set forth in FASB Statement No. 80 (AC F80). If hedge accounting is considered appropriate, the auditor should then consider whether the oil and gas producer has disclosed the effect of hedging on the reserve information required by FASB Statement No. 69 (AC Oi5).

.49 As they evaluate the propriety of presentation and disclosure of hedging activities in the financial statements, auditors should be aware that FASB Statement No. 104, *Statement of Cash Flows—Net Reporting of Certain Cash Receipts and Cash Payments and Classification of Cash Flows from Hedging Transactions* (AC C25), states that the cash flows resulting from future, forward, option, or swap contracts that are accounted for as hedges of identifiable transactions or events may be classified in the same category as the items being hedged in the statement of cash flows and disclosed as a separate line item if material.

Restructuring Charges

.50 For a number of reasons, including economic conditions and disappointing operating results in recent years, many oil and gas producers are continuing to restructure their operations. In evaluating the propriety of accounting for restructurings, auditors should be aware that restructuring charges should include only costs that are a direct result and an integral part of the restructuring decision and that such charges should be presented as a separate component of income from continuing operations, if material. Auditors should refer to EITF Issue No. 87-4, *Restructuring of Operations: Implications of SEC Staff Accounting Bulletin No. 67* for further guidance on the appropriate accounting for restructurings. Restructuring charges typically do not relate to the disposal of a segment of a business, as defined in APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions* (AC I13), nor do they qualify as extraordinary items as defined in accounting literature. SAB No. 67 sets forth the view of the SEC staff regarding the presentation of restructuring charges by publicly traded companies.

Disclosures—Publicly Held Companies

.51 *Management's Discussion and Analysis.* SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AU section 550), requires that auditors read such information and consider whether it and the manner of its presentation are materially consistent with information appearing in the financial statements. As auditors of oil and gas producers that are required to file reports with the SEC read the Management's Discussion and Analysis of Operations (MD&A) sections of SEC filings, they might consider whether the MD&A includes discussions of—

- The impact of recently issued accounting standards which are not effective until some future date. If the adoption of a standard is expected to have a significant effect on the oil and gas producer's financial position or results of operations, the MD&A disclosure should (1) notify that a standard has been issued which the oil and gas producer will be required to adopt in the future, and (2) assess the significance of the impact that the adoption of the standard should have on the company's financial statements (unless this cannot reasonably be estimated, in which case, a statement to that effect should be made).

- The effects of hedging on liquidity and results of operations.

- Known trends, demands, commitments, events, or uncertainties that are reasonably likely to have a material effect on the oil and gas producer's results of operations or financial condition.

AICPA Audit and Accounting Literature

Audit and Accounting Guide

.52 The AICPA Audit and Accounting Guide *Audits of Entities with Oil and Gas Producing Activities* is available through the AICPA's loose-leaf subscription services. In the loose-leaf service, conforming changes (those necessitated by the issuance of new authoritative pronouncements) and other minor changes that do not require due process are incorporated periodically. Paperback editions of the guides as they appear in the service are printed annually.

Oil and Gas Producers' Financial Reporting Checklist

.53 The AICPA's Technical Information Service has published a revised version of *Checklist Supplement and Illustrative Financial Statements for Oil and Gas Producing Companies* as a tool for preparers and reviewers of financial statements of oil and gas producers. Copies may be obtained by calling the AICPA Order Department.

Technical Practice Aids Publication

.54 *Technical Practice Aids* is an AICPA publication that, among other things, contains questions received by the AICPA's Technical Information Service on various subjects and the service's responses to those questions. *Technical Practice Aids* contains questions and answers specifically pertaining to oil and gas producing entities. *Technical Practice Aids* is available both as a subscription service and in hardcover form. Order information may be obtained from the AICPA Order Department.

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.55 This Audit Risk Alert replaces *Oil and Gas Producers Industry Developments—1992.*

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.56 Practitioners should also be aware of the economic, regulatory, and professional developments in *Audit Risk Alert—1993* [AAM section 8010] and *Compilation and Review Alert—1993* [AAM section 8015].

[The next page is 8355.]

AAM Section 8170
Securities Industry Developments—1993

Industry and Economic Developments

.01 The securities industry appears to be continuing its record of strong growth. For the year ended December 31, 1992, New York Stock Exchange (NYSE) member firms dealing with the public set records with revenues of $62.8 billion, profits before income taxes of $6.2 billion, an average pretax return on equity of 22.8 percent, and an average daily volume of over 202 million shares. Current trends portend new records for year-end 1993. Trading and underwriting activities continue to increase as capital moves from traditional, low-yield investments to higher-yield and frequently more complex investments.

.02 Several trends in particular seem to be dominating the environment in which securities broker-dealers operate: continued development of new and increasingly complex financial products and services, continued expansion of the marketplace around the globe, and continued emphasis on cost containment. Trends such as these tend to significantly increase the business risks to which entities in the securities industry are subjected and, as a result, may increase audit risk as well.

.03 The development of new financial products and services along with innovative and complex trading and other business strategies has had a dramatic effect on the risks associated with the industry. In an environment in which trading strategies often involve foreign currency, arbitrage, options, global trading, and complicated financing arrangements, there are increased risks that relate to the complexity of the strategies as well as to the traditional credit, liquidity, and operational risks. Auditors of broker-dealers should understand the new products and services offered by their clients, the underlying trading and financing strategies, the means of executing and processing the transactions and the risks associated with all of those factors.

.04 As a growing number of countries are breaking down the legal and regulatory barriers in their financial markets, the industry is finding itself operating in a global marketplace where trading takes place virtually around the clock. As firms actively pursue business operations in such countries, they assume additional risks as well. For example, control procedures to assess market and credit risks must be extended to cover global operations.

.05 The continuing emphasis on cost control in the industry may have audit risk implications as well. Tens of thousands of jobs in the industry have been eliminated since the stock market crash of 1987 and a number of firms are finding that some activities can better be handled by a few firms acting on behalf of many. One example of this trend is the development of the practice of correspondent clearing, in which one firm may offer clearing services for dozens or hundreds of other firms. Auditors of broker-dealers that use such services should consider how the use of services provided by such organizations might affect the audit procedures they perform.

.06 Over the last decade technology has transformed the manner in which business is conducted and the variety of products that can be offered. In addition, buyer demographics have shifted, with increasing numbers of institutional investors and baby boomers arriving to invest. As a result, pressure to remain competitive has significantly intensified.

.07 Because interest rates are at historic lows (compared to the past decade) and price-earnings ratios of stocks are very high, a drop in stock prices could reduce transaction activity in the secondary market as well as discourage new stock issues in the primary market. An increase in interest rates could cause a similar contraction in bond trading.

Regulatory Developments

.08 AICPA Statement on Auditing Standards (SAS) No. 22, *Planning and Supervision* (AU section 311), requires that in planning their audits, auditors consider matters affecting the industry in which an entity operates, including, among other things, government regulations. Auditors consider such regulations in light of their potential impact on the financial statements being audited. SAS No. 54, *Illegal Acts by Clients* (AU section 317), distinguishes between two types of laws and regulations:

- Those that have a direct and material effect on the determination of financial statement amounts
- Those that relate more to an entity's operating aspects than to its financial and accounting aspects and therefore have only an indirect effect on the financial statements

While auditors should design their audits to provide reasonable assurance of detecting material misstatements of the financial statements resulting from illegal acts that have a direct and material effect on the determination of financial statement amounts, an audit performed in accordance with generally accepted auditing standards does not include procedures specifically designed to detect illegal acts that would have only an indirect effect on the financial statements. Nonetheless, auditors should be aware of the possibility that such illegal acts may have occurred.

.09 The securities industry is subject to extensive regulation by a number of federal and state authorities. As a result, auditors of broker-dealers should be familiar with applicable rules and regulations of governmental agencies and other regulatory bodies, including the Securities and Exchange Commission (SEC), and industry member regulatory bodies such as the National Association of Securities Dealers and national securities exchanges such as the New York Stock Exchange.

.10 Auditors of broker-dealers that are also commodities brokers should also consider rules and regulations of the Commodity Futures Trading Commission (CFTC). The CFTC was created by Congress in 1974 and is the federal agency with regulatory and oversight responsibility for the trading of commodity futures and options contracts on the U.S. futures exchanges. Since 1982, the CFTC has also regulated operations on futures contracts and options on physical commodities trading on commodity markets.

.11 A summary of some of the recent regulatory developments that may affect the audits of broker-dealers follows.

Minimum Capital Requirements

.12 SEC rule 15c3-1 prescribes net capital requirements for broker-dealers. In November 1992, the SEC issued final rule amendments (Release No. 34-31511) to the net capital rule. The amendments raise the minimum net capital required of certain registered broker-dealers as follows:

1. Broker-dealers that hold customer funds or securities will be required to maintain at least $250,000 in net capital.
2. Broker-dealers that clear customer transactions but do not hold customer funds or securities beyond the settlement of the transaction will be subject to a $100,000 minimum net capital requirement.
3. Broker-dealers that introduce customer accounts to other broker-dealers will be required to maintain $50,000 or $5,000 in minimum net capital, depending on whether or not they receive securities. Broker-dealers that make markets in certain securities will be required to maintain greater net capital in proportion to the number of securities in which they make markets. The maximum on this additional market-maker minimum net capital requirement will be raised from $100,000 to $1,000,000.
4. The minimum net capital requirement for certain mutual fund broker-dealers will be increased to $25,000.

The amendments also prescribe standardized "haircuts" that must be taken in computing both basic and alternative net capital requirements and revisions to the computation of aggregate indebtedness.

.13 The amendments will be implemented over a period of eighteen months, beginning January 1, 1993.

Haircut Rules for Derivatives and Other Sophisticated Financial Instruments

.14 The SEC staff is continuing its review of the application of its haircut rules to sophisticated financial instruments such as collateralized mortgage obligations (CMOs). Currently, CMOs issued by government agencies or government-sponsored enterprises, such as Fannie Mae or Freddie Mac, are afforded the same haircut treatment as U.S. government securities. Privately issued CMOs are afforded the same haircut treatment as corporate bonds, based on the CMOs' ratings by independent securities rating agencies such as Standard & Poor's. The SEC is considering creating a separate haircut treatment under which CMOs would be assigned haircuts related to their risk attributes.

.15 The SEC has issued a concepts release on derivative products (Release No. 34-32256), which addresses the issue of how such products should be treated in computing broker-dealers' statutory net capital requirements. The SEC broadly defines a derivative product as a financial instrument that derives its value from the performance of other assets, including securities, interest rates, or indexes. The current net capital treatment of financial instruments used in formulating derivatives is described in the release and includes listed and unlisted options, swaps, forwards, futures, and options on futures. Credit risk is also recognized as a significant risk in derivative products. The SEC is requesting comments on the appropriate capital treatment to reflect the risks of over-the-counter derivative products and has posed twenty-one questions for comment.

Record Preservation Rule

.16 The SEC has proposed amendments to the broker-dealer record preservation rule (Release No. 34-32609), that would allow broker-dealers, under certain conditions, to employ optical storage technology to maintain required records. Another proposed amendment would codify a staff interpretation that allows broker-dealers to use microfiche for record-retention purposes.

.17 The CFTC has amended its general record-keeping rules (FR 27458) to permit substantially similar record-retention compliance.

Ready Marketability of Foreign-Equity Securities

.18 The SEC staff has taken an interim no-action position, which permits broker-dealers to treat foreign-equity securities that are listed on the FT-A World Indices as having a ready market in computing statutory net capital requirements. The SEC has also issued a concepts release (Release No. 34-32748), which solicits comments on a number of questions regarding the treatment of foreign-equity securities under the ready-market provisions of the net capital rule, rule 15c3-1, of the Securities Exchange Act of 1934. Following receipt of public comments, the SEC intends to determine whether proposed rule making or other action is appropriate.

FOCUS Report Revision

.19 The staffs of the SEC and the CFTC, in cooperation with the Capital Committee of the Securities Industry Association, are revising the Financial and Operational Combined Uniform Single (FOCUS) report, which is the uniform regulatory report required to be filed with regulators. The CFTC permits futures commission merchants (FCMs) who are also registered broker-dealers to file the FOCUS report instead of the currently required CFTC Form 1-FR. After the revised FOCUS report has been approved for use, the CFTC intends to allow FCMs, whether or not they are broker-dealers, to file CFTC reports using the new FOCUS report. The revised report is expected to prohibit broker-dealers from including subordinated debt in a combined total with equity on the balance sheet. However, no change is anticipated that would prohibit including qualifying subordinated debt in regulatory net capital.

CFTC Developments

.20 *Introducing Broker Reporting.* The CFTC amended its financial reporting requirements for introducing brokers (58-FR 10949) to reduce the minimum number of financial reports required to be filed from four to two: a year-end audited report and an unaudited mid-year report. In addition, the CFTC deleted the requirement that an introducing broker file copies of early warning notices that it files with the National Futures Association (the designated self-regulatory organization for introducing brokers) pursuant to regulation 1.12. Those rule changes became effective on March 23, 1993.

Internal Revenue Service Developments

.21 The Internal Revenue Service (IRS) has increased its emphasis on information-reporting compliance. The daily sale and purchase of securities and frequent cash distributions made by broker-dealers as brokers for third parties subject them to numerous IRS reporting regulations. Failure to properly file information returns, such as Form 1099DIV reporting dividends to shareholders, with the IRS can result in substantial penalties.

Audit Issues and Developments

Derivatives and Other High-Risk Investments

.22 Recent years have seen a growing use of innovative financial instruments that often are very complex and can involve a substantial risk of loss. Users and issuers of such instruments must have the expertise necessary to understand and manage the related risks. As discussed below, auditors should also be familiar with such instruments and the associated risks. One class of instruments—derivatives—requires particular attention.

.23 Derivatives are complex financial instruments whose values depend on the values of one or more underlying assets or financial indexes. Derivatives generally fall into at least two categories:

1. Asset-backed securities, which include mortgage-backed securities, interest-only and principal-only strips, and tranches of collateralized mortgage obligations

2. Off-balance-sheet instruments such as forward contracts, interest-rate and currency swaps, futures, options and other financial contracts

.24 Some of the specific derivatives and financial instruments with which auditors of broker-dealers should be familiar include—

- Interest-rate swaps, which are agreements between counterparties to exchange periodic payments based on specific interest-rate differentials applied to a specified notional amount. A swap allows one party to effectively change the interest-rate structure of a debt obligation or of an investment through the exchange of payments with another party. Swaps enable participants to obtain financing from the cheapest markets and simultaneously hedge unwanted risks.

- Cap agreements, which provide that during a specified period a seller will pay a buyer the excess of the prevailing market interest rate over a specified index rate (cap index rate) on a notional amount whenever the index rate is above the protected interest rate on a rate determination date (option or ceiling rate). Cap agreements provide entities that have outstanding floating-rate debt with protection against rising interest rates.

- Floor agreements, which provide that during a specified period a seller will pay a buyer the excess of a specified minimum rate (floor) over a specified index market rate on a notional amount whenever the index rate falls below a specified point. A floor agreement provides the owner of a floating-rate asset with a guaranteed minimum return.

- Interest-rate swap options ("swaptions"), which allow buyers to enter into or exit an interest-rate swap transaction at a future date, at a specified interest rate based on a notional amount.
- Commodity swaps, which are similar to interest-rate swaps except that the underlying index is usually based on the price of a commodity, such as metals, energy products, or grains.
- Equity-derivative products, which include longer-term warrants or options on indexes or equities that are customized to a particular client's needs.

By reconfiguring cash flows associated with underlying assets, an issuer can create asset-backed securities that meet the needs of and are attractive to various potential users by isolating, enhancing, or diluting one or more of credit, liquidity, interest rate, and other risks inherent in the underlying cash flows. For example, through mortgage-backed securities, the issuer can enhance the marketability of underlying mortgage loans by spreading liquidity and credit risk across broad pools, or by providing a higher yield to those users willing to accept a higher concentration of the risks associated with specific collateral cash flows. Similarly, users find certain derivatives attractive because they can purchase the risks and rewards they desire most, or can synthetically create a security with the desired risk and reward characteristics.

.25 Increased volatility of interest rates, foreign exchange rates, and commodity and other prices has also fostered tremendous innovation in financial products to meet the needs of users attempting to hedge or alter the related risks. Swaps, for example, are financial contracts in which two parties exchange streams of payments over a period of time. An entity with debt that carries variable interest rates (such as an entity that has short-term certificates of deposit) might swap interest-rate payments on an agreed-upon principal amount with a counterparty by paying a fixed rate and receiving a variable rate. The entity locks into an interest rate for the term of the swap, reducing the risk that increases in interest rates will increase the entity's cost of funds as its liabilities are refunded or related interest rates are reset. The entity takes on other risks, however, such as the risk that the counterparty could default on its payments. By locking into fixed rates, the entity will no longer benefit from interest rate decreases during the term of the swap and it is often costly to terminate a swap. Further, the fair value of derivatives can be volatile in periods of changing market conditions.

.26 *Accounting.* Accounting for derivatives is complex. The AICPA Audit and Accounting Guide *Audits of Brokers and Dealers in Securities* includes detailed discussions of accounting for specific types of securities, including a number of derivatives. Given the constant innovation and complexity of derivatives, accounting literature does not explicitly cover some derivatives, though, several related projects are underway.

.27 The Financial Accounting Standards Board (FASB) has been carrying out a major project on the recognition and measurement of financial instruments, which has already resulted in the issuance of FASB Statements of Financial Accounting Standards No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (AC F25), and No. 107, *Disclosures about Fair Value of Financial Instruments* (AC F25), and FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts* (AC B10), that address related issues. The FASB's project includes a comprehensive review of accounting for hedging and risk-adjusting derivatives. Also, the International Accounting Standards Committee is in the process of developing an international accounting standard for financial instruments.

.28 Several accounting issues involving derivatives have also been addressed by the FASB's Emerging Issues Task Force (EITF). Other guidance is provided by FASB Statements of Financial Accounting Standards No. 52, *Foreign Currency Translation* (AC F60), and No. 80, *Accounting for Futures Contracts* (AC F80). In addition, AICPA Issues Paper No. 86-2, *Accounting for Options,* discusses various matters related to options.

.29 *Auditing.* The innovative and complex nature of such investment vehicles may significantly increase audit risk. For example, as more and more financial institutions enter the markets for such instruments, their profitability may diminish. Traders may attempt to compensate for the diminution by increasing the volume of transactions involving such instruments or by further customizing products. An increase in volume may be accompanied by trading with counterparties that have higher credit risk. Customizing transactions may increase valuation difficulties. The propriety of the methods used by the managements of broker-dealers to account for transactions involving sophisticated financial instruments and to determine their value should be carefully considered. The substance of transactions in such instruments, rather than their form, should be a primary factor in determining the propriety of their accounting treatment. In some circumstances, auditors may find it helpful to consult with experts.

.30 SAS No. 22 (AU section 311) requires that auditors understand the events, transactions, and practices that, in their judgment, may have a significant effect on the financial statements. Accordingly, auditors should carefully consider the various risks involved with investments in derivatives and other complex securities as they plan their audits and should—

1. Assess management's expertise in monitoring, evaluating, and accounting for the securities.
2. Ensure that the entity has set appropriate policies and procedures for investment in high-risk securities and that there is adequate oversight by the board of directors.
3. Involve specialists, when necessary, in valuing and auditing these investments.

High-Risk Transactions

.31 Securities firms often engage in transactions that present inherent risks unique to the industry. Such transactions include—

- Securities lending, the inherent risks of which include the possibility that the counterparty will fail to return either the securities borrowed or the collateral, resulting in the need to buy or sell the securities at a possible loss.
- Repo transactions, which present risks similar to those presented by securities lending.
- Risk arbitrage, which involves investments in securities of entities that are engaged in mergers or tender offers. Such investments present exposure to the risk that the merger will not be completed successfully. Such aborted mergers may precipitate dramatic declines in securities prices, resulting in loss to the investors.
- Tender offers, in which one company makes an offer for a specific number of shares of another company, reserving the option to accept all stock tendered over the minimum as well as a lesser number of shares. In this type of transaction, the price offered usually is substantially higher than the current market price of the securities. The risk, or exposure, to the firm relates to the possibility that the shares may not be accepted.
- Underwriting of securities, the unique inherent risks of which include the possibility that underwriters may be required to purchase unsold securities positions offered pursuant to a firm commitment underwriting. As a result, a securities firm may need to finance the securities, assume the market risk of ownership, and take haircuts pursuant to rule 15c3-1. Underwriting securities also presents the risk that lawsuits may also be initiated by the purchasers of the securities under Section 11 of the Securities Act of 1933, which specifies that all persons (including underwriters) connected with a registration statement have responsibility for material misstatements contained therein. Securities underwriting also presents the risk that customers who have committed to purchase securities being underwritten may refuse to honor their commitments, resulting in the underwriter's having to purchase the securities.

Service-Center-Produced Records

.32 Broker-dealers frequently operate in an environment in which service organizations functioning as service agents, fund custodians, or transfer agents, or in other administrative capacities, play a critical role in the accounting function. In assessing control risk in such an environment, auditors must carefully consider the functions or processing of information performed by the service organizations. SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AU section 324), which was issued in April 1992 and supersedes SAS No. 44, *Special-Purpose Reports on Internal Accounting Control at Service Organizations,* provides guidance to auditors performing audits of investment companies that use such organizations.

.33 When a broker-dealer uses a service organization, the functions or processing performed by the service organization may have a significant effect on the broker-dealer's financial statements. Because the processing may be subjected to control policies and procedures that are physically and operationally separate from the broker-dealer, the internal control structure of the broker-dealer may include a component that is not directly under the control and monitoring of its management. SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AU section 319), requires an auditor to obtain a sufficient understanding of an entity's internal control structure to plan an audit. For this reason, planning the audit of a broker-dealer may require that the auditor gain an understanding of the control policies and procedures performed by service organizations. When a broker-dealer relies on a service organization's control policies and procedures over the processing of transactions that are material to the broker-dealer's financial statements, those control procedures should be considered by the auditor. One method of obtaining information about those policies and procedures is to obtain a service auditor's report as described in SAS No. 70 (AU section 324).

.34 Auditors frequently inquire whether it is necessary to obtain a service auditor's report when their clients use service organizations. The fact that an entity uses such an organization does not in itself require that such a report must be obtained. In certain situations, the broker-dealer may implement control policies and procedures that will obviate the need for a service auditor's report. For example, a broker-dealer using a payroll service may routinely compare the data submitted to the service organization with reports received from the service organization to check the completeness and accuracy of the data processed. The broker-dealer may also recompute a sample of the payroll checks for clerical accuracy and review the total payroll for reasonableness. In such circumstances, the broker-dealer is not relying on the service organization's controls.

.35 Other factors that may be considered in determining whether to obtain a service auditor's report are—

- Whether the transactions or accounts affected by the service organization are material to the broker-dealer's financial statements.
- The extent to which the broker-dealer retains responsibility for authorizing the transactions and maintaining the related accountability.
- The availability of other information (for example, user manuals, system overviews, and technical manuals) at the investment company that may provide the auditor with sufficient information to plan the audit.

The AICPA's Auditing Standards Division expects to issue an Auditing Procedure Study, *Implementing SAS No. 70, Reports on the Processing of Transactions by Service Organizations,* early in 1994.

Reporting on Internal Control

.36 In May 1993, the AICPA's Auditing Standards Board (ASB) issued Statement on Standards for Attestation Engagements (SSAE) No. 2, *Reporting on an Entity's Internal Control Structure Over Financial Reporting* (AT section 400), which is effective for examinations of the efficacy of an entity's internal control structure over financial reporting when the entity's assertion is as of December 15, 1993, or thereafter. SSAE No. 2 (AT section 400) provides guidance to accountants who are engaged to examine and report on management's written assertions about the effectiveness of an entity's internal control structure over financial reporting as of a certain point in time. The Statement does *not* change the auditor's responsibility to consider the entity's internal control structure over financial reporting in an audit of financial statements.

.37 SEC rule 17a-5 requires a report on the internal control structure of a broker-dealer. Reports prepared to meet the requirements of rule 17a-5 are exempted from the scope of SSAE No. 2 (AT section 400). The Audit and Accounting Guide *Audits of Brokers and Dealers in Securities* includes an illustration of a report that meets the requirements of rule 17a-5.

Accounting Developments

Revised Audit and Accounting Guide

.38 The AICPA Stockbrokerage and Investment Banking Committee has prepared for exposure a revised version of the Audit and Accounting Guide *Audits of Brokers and Dealers in Securities.* The proposed guide focuses on special matters unique to auditing and reporting on financial statements of broker-dealers. The proposed guide describes the conditions or procedures unique to the industry and illustrates the form and content of broker-dealer financial statements. Included are discussions of business activities, accounting records, internal control policies and procedures (including those for safeguarding customer securities), unique aspects of the audit, and illustrations of various financial statements and independent auditors' reports.

.39 The draft is expected to be exposed for comment in the first half of 1994.

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.40 This Audit Risk Alert replaces *Securities Industry Developments—1992.*

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.41 Auditors should also be aware of the economic, regulatory, and professional developments that may affect the audits they perform, as described in *Audit Risk Alert—1993* [AAM section 8010].

[The next page is 8375.]

AAM Section 8180

Not-for-Profit Organizations Industry Developments—1994

Industry and Economic Developments

.01 Although the U.S. economy continues its slow recovery, the effects have not yet reached the not-for-profit sector. Many individuals, still facing financial concerns and skeptical about the efficiency of not-for-profit organizations, have dramatically reduced their levels of charitable giving. Corporate giving fell by 1.3 percent last year (4.2 percent adjusted for inflation)—the first time corporate donations have dropped in over two decades. Funding from private foundations was on the decline as foundations adjusted to lower earnings on their investment portfolios, but is now stabilizing. However, this funding is being focused on projects that are apt to make long-term societal differences. Also, many organizations continue to experience reduced funding from state and local governments. In addition, interest rates declined to their lowest levels in years before beginning to show modest increases, making it increasingly difficult for organizations to maintain levels of return on their interest-earning investments. However, increases in gains on equity and debt securities have resulted in some not-for-profit organizations increasing their returns on investment portfolios.

.02 The media continues to focus attention on other issues relating to not-for-profit organizations. First among them continues to be the reasonableness of compensation, fringe benefits, and perquisites afforded to the senior management personnel of some organizations. Other issues highlighted include the amounts of assets held by not-for-profit organizations, the portion of revenue earned from fees for goods or services, and the perception that expenditures for program services are a low portion of total expenditures. The adverse publicity concerning such issues continues to make many donors less willing to continue contributing at levels they maintained in the past. Furthermore, questions raised about the personal inurement of executives threaten the tax-exempt status of the organizations they serve.

.03 As a result of changes in not-for-profit funding and increased scrutiny, not-for-profit organizations continue to experience pressure to try to present financial statements that make their operations appear as efficient as possible. Auditors should consider the effect that such pressures may have on audit risk, particularly that associated with areas such as allocation of costs between program services and support services.

Regulatory and Legislative Developments

State and Local Issues

.04 State and local laws concerning not-for-profit organizations continue to change. The American Association of Fund-Raising Councils, Inc. (AAFRC) publishes its *Annual Survey of State Laws Regulating Charitable Solicitations* (available for $10) and the *Legislative Monitor* (available for $250 for an annual subscription). Copies of these publications can be obtained by calling (212) 354–5799 or by writing to the AAFRC at 25 West 43d Street, New York, NY 10036.

IRS Activities

.05 The Omnibus Budget Reconciliation Act, generally effective for not-for-profit organizations beginning on January 1, 1994, will significantly affect not-for-profit organizations and their donors. Provisions of the Act include the following:

- When a donor makes a "quid pro quo" payment in excess of $75 to an exempt organization partly as a contribution and partly in consideration for goods or services (for example, a ticket to a concert), the organization is required to provide the donor with a written statement including (1) a good faith estimate of the value of such goods and services, and (2) a statement informing the donor that charitable contributions are tax-deductible only to the extent that they exceed the estimated value of the goods or services provided. Organizations can incur penalties for failing to make the disclosures.

- Contributions with a value of $250 or more will be disallowed unless the donor receives written acknowledgment from the organization. The acknowledgment must include the amount of the cash received, a description of any property other than cash donated (the organization should not value property other than cash because it is not an appraiser), a description of any goods or services the organization provided in exchange for the cash or property received, and a good-faith estimate of the value of such goods or services provided by the organization. Canceled checks will no longer suffice as documentation to substantiate contributions of $250 or more.

- The new law disallows donor deductions for payments, including membership dues, to organizations other than 501(c)(3) organizations to the extent that those payments are used for lobbying. Organizations are required to report to donors and members the nondeductible portion of their dues or other payments or pay a proxy tax. The new law also redefines the types of activities deemed to be lobbying. The Internal Revenue Service (IRS) has issued Notice 93-55, Announcement 94-8, and proposed regulation 1.162-28 to clarify these requirements, including transitional rules.

.06 The IRS continues to look for the existence of unrelated business activities, especially in the area of corporate sponsorship of sporting, cultural, and charity events conducted by exempt organizations. Under proposed regulations, the IRS would not classify as unrelated business income advertising involving corporate sponsorship so long as there is no encouragement to make a purchase. For example, advertising displaying a sponsor's name on the scoreboard would probably not be subject to Unrelated Business Income Tax (UBIT) under the proposed regulation; however, advertising displaying "Buy X Company Gasoline" would be subject to UBIT.

.07 In May 1993, in the case of *Sierra Club, Inc. v. Commissioner,* the Tax Court ruled that the charging of fees in exchange for the use of the organization's donor mailing list constituted royalty income and was thus excluded from unrelated business income.

.08 The IRS 1994 work plan for exempt organizations will cover a range of issues including the Coordinated Examination Program (CEP), which primarily focuses on colleges and universities and health care organizations. In general, college CEP audits are raising UBIT issues.

.09 The Internal Revenue Code prohibits private inurement of employees of certain tax-exempt organizations. Certain organizations can lose their tax-exempt status if their net earnings inure to the benefit of any private shareholder or if they are organized or operated for the private benefit of individuals instead of the exempt purposes for which they were granted tax-exempt status. The Exempt Organization Reform Act of 1993, which has been introduced but has not been passed, would impose a two-tier set of excise taxes on Section 501(c)(3) and (4) organizations and participating managers on certain acts of private inurement. Other proposals are expected to be introduced over the next year.

.10 Failure to comply with IRS regulations may result in (1) fines and penalties, (2) alienating donors and therefore losing potential future revenues, and (3) incurring additional tax liabilities. The auditor's responsibility concerning the organization's compliance with IRS regulations is discussed in paragraphs .22 and .23.

OMB Circular A-133

.11 Many not-for-profit organizations are required to have audits in accordance with OMB Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions.* The President's Council on Integrity and Efficiency (PCIE) issues statistics concerning the results of Inspector General (IG) reviews of audits of federal activities performed by independent public accountants. The statistics based on reviews for the six months ended March 31, 1993, indicate that federal Inspectors General continue to find deficiencies that cause them to reject audit reports. Specifically, 41 percent of the A-133 audit reports submitted for federal review required major changes.

.12 Some of the more common deficiencies include—

- Incomplete auditor's reports. Reports on the internal control structure or on compliance with applicable laws and regulations were missing, or did not include all the required information.
- Noncompliance with *Government Auditing Standards* (GAS or the Yellow Book), issued by the Comptroller General of the United States. This includes failure to obtain an adequate understanding of the internal control structure to plan the audit and to determine the nature, timing, and extent of tests to be performed; inadequate documentation of testing of compliance with applicable laws and regulations; and failure to report all findings.
- Incomplete schedules of federal financial assistance. This includes omission of the Catalog of Federal Domestic Assistance number or other identification of the awarding agency.
- Failure to adequately group awards by program, leading to concerns about whether major programs are properly identified.
- Piecemeal reports, which do not cover all major programs.
- Failure to submit management letters with single audit reports.

Government Auditing Standards

.13 The U.S. General Accounting Office (GAO) is expected to issue final revised *Government Auditing Standards* in June 1994. The standards for financial audits are expected to be effective for periods ending on or after January 1, 1995. Significant changes are expected to the proposed standards GAO exposed for comment in July 1993. In particular, the final standards will offer *guidance* on internal controls in place of the expanded testing *requirements* that had been proposed. The revised standards are expected to—

- Add a requirement for both government and nongovernment audit organizations to submit a copy of their most recent external quality control review report to the party contracting for an audit.
- Add a requirement to design the audit to detect noncompliance with contract provisions and grant agreements that could have a direct and material effect on financial statement amounts.
- Add a requirement that working papers identify client documents and transactions the auditor examined.
- Add a requirement for the auditor to communicate to audit committees or other responsible parties the auditor's responsibilities for consideration of internal controls and compliance with laws and regulations.
- Add a requirement to include a reference to GAS in audit reports when they are being submitted in accordance with law or regulation calling for a GAS audit.
- Add a requirement that the report on the financial statements either (1) describe the results of the auditor's tests of internal controls and compliance or (2) refer to separate reports on controls and compliance.
- Add a requirement that the auditor report irregularities and illegal acts directly to parties outside the client, even if they have resigned or been dismissed from the audit.
- Delete the requirement to describe categories of internal controls in the report on internal controls.

- Delete the requirement to express positive and negative assurance on compliance with laws and regulations.
- Incorporate relevant AICPA Statements on Auditing Standards (SASs), for example, SAS No. 62, *Special Reports* (AU section 623) and attestation standards into the GAS standards for financial audits.

Auditors should be mindful that the Yellow Book applies to OMB A-133 audits and also includes general standards, such as standards for (*a*) continuing professional education and (*b*) the auditor's participation in external quality control review programs. Statement of Position (SOP) 92-9, *Audits of Not-for-Profit Organizations Receiving Federal Awards,* provides guidance concerning audits conducted in accordance with the Yellow Book and OMB Circular A-133.

OMB Circular A-21

.14 In July 1993, the OMB published final revisions to OMB Circular A-21, *Cost Principles for Educational Institutions.* The revisions are effective for fiscal years beginning on or after January 1, 1994. Earlier implementation is encouraged.

.15 The revisions clarify and standardize the principles for determining costs applicable to grants, contracts, and other agreements with educational institutions.

.16 Copies of the circular may be obtained from the Office of Administration, Publication Office, Room 2200, New Executive Office Building, Washington, D.C. 20503; (202) 395-7332.

OMB Circular A-110

.17 In November 1993, the OMB published final revisions to OMB Circular A-110, *Uniform Administrative Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals, and Other Nonprofit Organizations.* The Circular applies to all federal agencies and includes adoption of the audit requirements of OMB Circular A-133, making it applicable to all universities, hospitals, and not-for-profit organizations receiving federal financial assistance. The Circular includes pre-award, post-award, and after-the-award requirements for administering grants and agreements. Among the requirements are standards for financial and program management, property management, and procurement systems and contract closeout procedures. Provisions that affect grantees will be adopted by agencies in codified regulations by May 30, 1994. Earlier implementation is encouraged.

.18 Copies of the circular may be obtained from the Office of Administration, Publication Office, Room 2200, New Executive Office Building, Washington, D.C. 20503; (202) 395-7332.

Arbitrage Regulations

.19 The term *arbitrage,* as it applies to not-for-profit organizations, refers to the ability of the organization to obtain funds from the issuance of tax-exempt bonds and invest those funds in investments with higher yields, resulting in a profit. Many organizations, including those in the field of higher education, are conducting, or planning to conduct, fund-raising campaigns to retire or reduce their tax-exempt bonds. In certain circumstances, the funds raised and invested for this purpose could be subject to the U.S. Treasury Department's arbitrage regulations, which require excess yields to be remitted to the government, and could be subject to fines and penalties.

CASB Standards

.20 The Cost Accounting Standards Board (CASB) has released a December 21, 1992, notice of proposed rulemaking, *Application of Cost Accounting Standards Board Regulations to Educational Institutions,* which is expected to be issued as a final rule soon. Unlike prior CASB standards, its coverage would extend to colleges and universities. The rule would provide cost accounting rules for pricing and costing goods and services procured with federal funds and would include certain disclosure requirements.

Audit Issues and Developments

Internal Control Structure

.21 Changes in financial accounting standards, changes in tax laws, increased attention to requirements to properly bill overhead costs to government agencies, and expanded contract audit requirements are resulting in the need for significant changes in the accounting and internal control systems of not-for-profit organizations. Auditors should ensure that they have a sufficient understanding of the organization's internal control structure in order to plan and perform the audit.

Compliance With IRS and Other Regulations

.22 Recent changes in tax laws, discussed in paragraphs .05 through .10, have resulted in the requirement that organizations keep accurate records concerning lobbying activities and the value of donated gifts, as well as providing written statements to donors. Failure to comply with some of the IRS requirements may result in fines and penalties.

.23 SAS No. 22, *Planning and Supervision* (AU section 311), requires that, in planning their audits, auditors consider matters affecting the industry in which the organization operates, including government regulations among other things. Auditors should consider such regulations in light of their potential impact on the financial statements being audited. SAS No. 54, *Illegal Acts by Clients* (AU section 317), distinguishes between the following two types of laws and regulations:

- Those that have a direct and material effect on the determination of financial statement amounts.
- Those that relate more to an entity's operating aspects than to its financial and accounting aspects and therefore have an indirect effect on the financial statements.

Although auditors should design their audits to provide reasonable assurance of detecting material misstatements of the financial statements resulting from illegal acts that have a direct and material effect on the determination of financial statement amounts, an audit performed in accordance with generally accepted auditing standards (GAAS) is not designed to detect illegal acts that would have only an indirect effect on the financial statements. Nonetheless, auditors should be aware of the possibility that such illegal acts may have occurred. If the auditor becomes aware that such illegal acts have or are likely to have occurred, the auditor should consider the effect on the financial statements as well as the implications for other aspects of the audit.

Management Compensation

.24 Some not-for-profit organizations continue to be criticized for providing their management with what are perceived by the media and the public to be excessive levels of compensation, fringe benefits, and perquisites. Such excessive levels, whether real or perceived, may result in reductions in donations due to negative publicity. As part of the auditor's consideration of the internal control structure, auditors should consider whether the organization has policies and controls to ensure that compensation, benefits, and perquisites are approved by the board of directors.

Investments

.25 In response to continued declines in support and declining interest rates, managers of the investments of many not-for-profit organizations are adopting increasingly aggressive investment strategies in order to maximize portfolio return. Generally, such strategies involve the purchase of more complex financial instruments, some of which may involve a substantial risk of loss. Investors in such instruments should have the expertise necessary to understand and manage the related risks. As discussed below, auditors should also be familiar with such instruments and the associated risks. One class of these instruments—derivatives—requires particular attention.

.26 Derivatives are complex financial instruments whose values depend on the values of one or more underlying assets or financial indexes. Derivatives generally fall into at least one of the following two categories:

- Asset-backed securities, which include mortgage-backed securities, interest-only and principal-only strips, and tranches of collateralized mortgage obligations
- Off-balance-sheet instruments such as forward contracts, interest-rate and currency swaps, futures, options, and other financial contracts

By reconfiguring cash flows associated with underlying assets, issuers of derivatives can create asset-backed securities that meet the needs of and are attractive to various potential users or investors by isolating, enhancing, or diluting one or more of credit, liquidity, interest-rate and other risks inherent in the underlying cash flows. For example, through mortgage-backed securities, the issuer can enhance the marketability of underlying mortgage loans by spreading liquidity and credit risk across broad pools, or by providing a higher yield to those users willing to accept a higher concentration of the risks associated with specific collateral cash flows. Similarly, users find certain derivatives attractive because they can purchase the risks and rewards they desire most, or can synthetically create a security with the desired risk and reward characteristics.

.27 Accounting for derivatives is complex. Given the constant innovation and complexity of derivatives, accounting literature doesn't explicitly cover some derivatives. However, several related projects are under way.

.28 The innovative and complex nature of such investment vehicles may significantly increase audit risk. For example, as more and more financial institutions enter the markets for such instruments, their profitability may diminish. Traders may attempt to compensate for the diminution by increasing the volume of transactions involving such instruments or by further customizing products. An increase in volume may be accompanied by trading with counterparties that have higher credit risk. Customizing transactions may increase valuation difficulties. The propriety of the methods used to account for transactions involving sophisticated financial instruments and to determine their value should be carefully considered. Understanding the substance of transactions in such instruments is important in determining the propriety of their accounting treatment. In some circumstances, auditors may find it helpful to consult with experts. SAS No. 22 (AU section 311) requires that an auditor understand the events, transactions, and practices that, in the auditor's judgment, may have a significant effect on the financial statements. Accordingly, auditors of the financial statements of investors in derivatives should be aware of the various risks involved with derivatives and, in planning the audit, should consider—

- The nature and extent of the use of derivatives.
- The level of expertise of the organization's investment managers in monitoring, evaluating, and accounting for derivatives.
- The policies and procedures established for investment in high-risk derivatives and the degree of oversight by the organization's management.
- The involvement of specialists in valuing derivatives.

The auditor should consider the work of any specialist used in valuing derivatives when auditing complex derivatives (see guidance in SAS No. 11, *Using the Work of a Specialist* (AU section 336). (SAS No. 11 is expected to be superseded by SAS No. 73, *Using the Work of a Specialist,* in July 1994.)

Creation of Affiliates and New Revenue Sources

.29 Continued reductions in sources of funding also have accelerated the trend whereby some not-for-profit organizations become affiliated with other entities or seek new revenue sources. Such arrangements may increase the risk that the organization will undertake operations that are outside management's traditional understanding and control. Such affiliations may also result in organizations undertaking new business ventures and investments. Auditors should consider whether such transactions result in violations of donor-imposed restrictions and whether they are accounted for in conformity with generally accepted accounting principles (GAAP). Also, auditors should consider management's level of expertise in dealing with such ventures or arrangements as they evaluate the control environment.

Environmental Liabilities

.30 Not-for-profit organizations often receive gifts of property from donors. Sometimes, property received by gift or otherwise acquired does not meet regulatory guidelines for environmental safety. The Environmental Protection Agency (EPA) is empowered by law to seek recovery from any party that ever owned or operated a contaminated site, or anyone who ever generated or transported hazardous materials to a site. In view of the liabilities that may result from owning contaminated sites, virtually all real estate transactions entered into today give consideration to potential environmental liabilities. Auditors of organizations that face such claims should carefully evaluate whether the accounting and disclosure requirements of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (AC C59), have been met. They should also be cognizant of the consensus reached by the FASB's Emerging Issues Task Force (EITF) in EITF Issue 93-5, *Accounting for Environmental Liabilities*, that, among other things, an environmental liability should be evaluated independently from any potential recovery and the loss arising from the recognition of an environmental liability should be reduced only when a claim for recovery is probable of realization.

.31 *Audit Risk Alert—1993* [AAM section 8010] contains further discussion of these matters.

Endowment Funds

.32 To cope with economic distress, some not-for-profit organizations may use endowment funds to finance current operations. Large interfund balances may be one indication of such usage. The use of endowment funds in such circumstances is governed by state law; the relevant law in many jurisdictions is the Uniform Management of Institutional Funds Act. Auditors should consider the nature of such funds and consider the effect of their use on the financial statements, and in that vein, on the auditor's report. Auditors should also consider the collectibility of such interfund balances. For example, it may be unreasonable to conclude that the operating fund will generate sufficient future revenues over expenses that are adequate to repay amounts borrowed from the endowment fund.

Deferred Gifts With High Rates of Return

.33 Forms of giving that involve annuities and other deferred giving arrangements are becoming more common. Some not-for-profit organizations continue to receive gifts with rates of return due to donors that exceed rates the organization is likely to earn on the gifts. In such circumstances, not-for-profit organizations may be liable for making up shortfalls between amounts due to donors and amounts earned on the investments. Auditors should consider whether such gifts are properly recorded in conformity with the relevant accounting principles, for example, chapter 10 of *Audits of Colleges and Universities* and paragraphs 121 to 123 of SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations.*

Indirect Costs Rates

.34 Some not-for-profit organizations receive funding under government contracts that include provisions to recoup indirect costs. Due to recent public disclosures of certain organizations overcharging the government for indirect costs and the implementation of OMB Circular A-133, the government has increased its scrutiny of charges billed to the government. Auditors should understand the internal control structure relating to indirect costs allocations and determine that allocations are appropriately presented in the financial statements. Auditors should consider the guidance in SAS No. 54 (AU section 317), concerning auditors' responsibilities to detect illegal acts. (The auditor's responsibilities under SAS No. 54 (AU section 317) are discussed in paragraph .23. SAS No. 68, *Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance* (AU section 801), and Chapter 5 of *Government Auditing Standards* provide additional guidance on the reporting of illegal acts that are detected.)

Tax-Exempt Debt Offerings

.35 Large not-for-profit organizations, such as colleges and universities, sometimes issue debt securities to finance construction projects or other activities. Such debt securities generally provide investors with income that is exempt from federal and some state income taxes. As a result of some large defaults in the tax-exempt bond market, the SEC has issued regulations concerning the underwriter's review and distribution of preliminary and final official statements prepared in connection with tax-exempt debt offerings. Although the regulations do not address the specific items that should be disclosed in offering statements, there is an increased concern on the part of the issuers, bond counsel, and others about whether adequate disclosures are being made.

.36 In February 1993, the AICPA issued SAS No. 72, *Letters for Underwriters and Certain Other Requesting Parties* (AU section 634). Historically, accountants have provided comfort letters to underwriters in connection with securities offerings registered pursuant to the Securities Act of 1933. SAS No. 72 (AU section 634) expands the availability of comfort letters beyond those underwriters to include (*a*) broker/dealers or other financial intermediaries in connection with the offering or placement of securities, and (*b*) buyers and sellers in connection with an acquisition when an exchange of stock is involved. These parties are required to provide the accountant with a letter making certain representations, as described in paragraphs 6 and 7 of the Statement (AU section 634.06 and .07). If the party requesting the comfort letter is unable to provide those representations, the accountant may not provide it with a comfort letter but may provide it with other services, such as a review under SAS No. 71, *Interim Financial Information* (AU section 722), or agreed-upon procedures under SAS No. 35, *Special Reports—Applying Agreed-upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement* (AU section 622).

Accounting Issues and Developments

Joint Costs

.37 In 1987, the AICPA issued SOP 87-2, *Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal.* SOP 87-2 provides guidance on reporting the costs of informational materials that include solicitations for financial support, and requires such costs to be reported as fund-raising expenses if it cannot be demonstrated that a bona fide program or a management and general function has been conducted in conjunction with the appeal for funds. If such activities other than appeals for funds can be demonstrated, such costs should be allocated between fund-raising and the related program or management and general function. Certain financial statement disclosures concerning such allocations are also required.

.38 Because of pressure to portray fund-raising expenses within certain percentages of revenue and expenses, there is an increased risk that the cost of mailing materials or conducting other communications with the public may not be properly allocated between program expenses and fund-raising or management and general expenses in conformity with SOP 87-2.

.39 Some state attorneys general continue to criticize the manner in which some organizations allocate joint costs. They believe some organizations have been too liberal in their allocation of costs to program expenses, especially those costs incurred to educate the public.

.40 Not-for-profit organizations and auditors should carefully review the requirements of the SOP and consider the sufficiency of evidence that exists to support any allocations of such joint costs.

.41 An AICPA exposure draft of a proposed SOP on this subject is discussed in paragraph .48 of this Alert.

Restrictions

.42 Pressure to attract donors to a particular cause or mission and to develop a level of consistent giving has resulted in some organizations soliciting contributions to emphasize specific activities or programs of the organization. In some cases, these solicitations are worded narrowly and effectively impose restrictions on the funds raised. Auditors should be familiar with the fund-raising materials used by the organization and consider whether the materials impose restrictions on the use of the funds raised.

Accounting Pronouncements and Projects

.43 *FASB Not-for-Profit Organizations Project.* The FASB is continuing its consideration of the specialized accounting principles and practices included in four AICPA audit and accounting guides relevant to not-for-profit organizations. The FASB added this project to its agenda in March 1986, initially to address accounting for contributions and the recognition of depreciation by not-for-profit organizations. The portion of the project dealing with depreciation was completed in September 1988 and resulted in FASB Statement No. 93, *Recognition of Depreciation by Not-for-Profit Organizations* (AC D40).

.44 *FASB Statement No. 116.* The portion of the project dealing with contributions was completed in June 1993 and resulted in FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made* (AC C67). The Statement requires the following:

- Contributions received, including unconditional promises to give, should generally be recognized as revenues in the period in which they are received at fair values.
- Conditional promises to give should be recognized when they become unconditional.
- Not-for-profit organizations should distinguish among contributions received that increase permanently restricted net assets, temporarily restricted net assets, and unrestricted net assets.
- The expiration of donor-imposed restrictions should be recognized in the period in which those restrictions expire.
- Certain exceptions are made for the recognition of contributions of services and works of art, historical treasures, and similar assets, including the following:
  - — Contributions of services should be recognized only if the services received (1) create or enhance nonfinancial assets or (2) require specialized skills, are provided by individuals possessing those skills, and would typically need to be purchased if not provided by donation.
  - — Contributions of works of art, historical treasures, and similar assets need not be recognized as revenues and capitalized if the donated items are added to collections held for public exhibition, education, or furtherance of public service rather than financial gain.
- Certain disclosures are required for collection items not capitalized and for receipts of contributed services and promises to give.

FASB Statement No. 116 (AC C67) is effective for financial statements issued for fiscal years beginning after December 15, 1994, and for interim periods within those fiscal years, except for not-for-profit organizations with less than $5 million in total assets and less than $1 million in annual expenses. For those organizations, the effective date shall be for fiscal years beginning after December 15, 1995. Earlier application is encouraged. Guidance in the AICPA Industry Audit Guides *Audits of Colleges and Universities* and *Audits of Voluntary Health and Welfare Organizations*, in SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*, and in the AICPA Audit and Accounting Guide *Audits of Certain Nonprofit Organiza-*

tions that is inconsistent with the guidance in FASB Statement No. 116 (AC C67) is superseded as of the application date of FASB Statement No. 116 (AC C67).

.45 *FASB Statement No. 117.* The portion of the project dealing with financial statement display was completed in June 1993 and resulted in FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations* (AC C25). The Statement provides guidance on the scope, form, and content of not-for-profit organizations' financial statements and requires the following:

- All not-for-profit organizations should provide a statement of financial position, a statement of activities, and a statement of cash flows.
- Amounts should be reported for total assets, liabilities, and net assets in a statement of financial position.
- The change in an entity's net assets should be reported in a statement of activities.
- The change in cash and cash equivalents should be reported in a statement of cash flows.
- Net assets, revenues, gains, and losses should be classified based on the existence or absence of donor-imposed restrictions, using the following three classes of net assets: permanently restricted, temporarily restricted, and unrestricted.
- Voluntary health and welfare organizations should provide a statement of functional expenses that reports expenses by both functional and natural classifications.

FASB Statement No. 117 (AC C25) is effective for annual financial statements issued for fiscal years beginning after December 15, 1994, except for organizations with less than $5 million in total assets and less than $1 million in annual expenses. For those organizations, the effective date shall be for fiscal years beginning after December 15, 1995. Earlier application is encouraged. Guidance in the AICPA Industry Audit Guides *Audits of Colleges and Universities* and *Audits of Voluntary Health and Welfare Organizations,* in SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations,* and in the AICPA Audit and Accounting Guide *Audits of Certain Nonprofit Organizations* that is inconsistent with the guidance in FASB Statement No. 117 (AC C25) is superseded as of the application date of FASB Statement No. 117 (AC C25).

.46 *GASB Statement No. 19.* The GASB issued Statement No. 19, *Governmental College and University Omnibus Statement,* in September 1993. GASB Statement No. 19 requires governmental colleges and universities that follow the AICPA College Guide model to report Pell grants in a restricted current fund. The Statement also requires that if a single fund is used to account for risk financing activities, that fund should be reported as an unrestricted current fund.

.47 For Pell grants, the Statement is effective for financial statements for periods beginning after June 15, 1993. For risk financing activities, the Statement is effective for financial statements for periods beginning after June 15, 1994. Early application is encouraged.

.48 *AcSEC Projects.* The AICPA Accounting Standards Executive Committee (AcSEC) is considering three proposed SOPs that provide guidance for not-for-profit organizations:

1. *The Application of the Requirements of Accounting Research Bulletins, Opinions of the Accounting Principles Board, and Statements and Interpretations of the Financial Accounting Standards Board to Not-for-Profit Organizations.* In May 1993, the AICPA Not-for-Profit Organizations Committee released an exposure draft of a proposed SOP that would require that such pronouncements be applied by not-for-profit organizations unless the pronouncements specifically exclude them, are not relevant to the kinds of transactions entered into by not-for-profit organizations, or pertain to topics also addressed in the AICPA Audit and Accounting Guides *Audits of Colleges and Universities, Audits of Providers of Health Care Services, Audits of Voluntary Health and Welfare Organizations,* or *Audits of Certain Nonprofit Organizations.* The SOP is expected to be issued in July 1994.

2. *Reporting of Related Entities by Not-for-Profit Organizations.* In May 1993, the AICPA Not-for-Profit Organizations Committee released an exposure draft of a proposed SOP that would amend and make uniform the guidance concerning reporting related entities in the AICPA Audit and Accounting Guides *Audits of Colleges and Universities* and *Audits of Voluntary Health and Welfare Organizations* and in SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations.* The proposed SOP would provide that the decision about whether the financial statements of a reporting not-for-profit organization and those of one or several other entities (either not-for-profit organizations or business entities) should be consolidated should be based on the relationship of the entities to each other. That relationship would also govern the disclosures that the reporting organization would be required to make. The guidance in the draft SOP focuses on investments in majority-owned for-profit subsidiaries and financially interrelated not-for-profit organizations. The SOP is expected to be issued in July 1994.

3. *Accounting for the Costs of Joint Activities.* In September 1993, the AICPA Not-for-Profit Organizations Committee released an exposure draft of a proposed SOP that would clarify and revise SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal.* The proposed SOP would be applied by not-for-profit organizations and state and local governmental entities in determining fund-raising costs. It would require reporting the costs of all materials and activities that include a fund-raising appeal as fund-raising costs, including costs that are otherwise clearly identifiable with program or management and general functions, unless a bona fide program or management and general function has been conducted in conjunction with the appeal for funds. If a bona fide program or management and general function has been conducted in conjunction with an appeal for funds, the joint costs of those activities would be allocated. Costs that are clearly identifiable with fund-raising, program, or management and general functions would be charged to that cost objective. The period for commenting on the exposure draft has expired and the committee is considering the comments received.

4. *AICPA Guide Project.* The AICPA currently has a project to perform a comprehensive review and revision of the AICPA Audit and Accounting Guides *Audits of Colleges and Universities* and *Audits of Voluntary Health and Welfare Organizations,* in SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations,* and in the AICPA Audit and Accounting Guide *Audits of Certain Nonprofit Organizations.* The objective of the project is to make the guides consistent with FASB Statements No. 116 (AC C67) and 117 (AC C25) and to provide further guidance.

* * * *

.49 This Audit Risk Alert supersedes *Not-for-Profit Organizations Industry Developments—1993.*

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.50 Auditors should also be aware of the economic, regulatory, and professional developments that may affect the audits they perform, as described in *Audit Risk Alert—1993* [AAM section 8010].

[The next page is 8401.]

AAM Section 8190
FDIC Improvement Act Implementation Issues

Introduction

.01 This document alerts CPAs to how the Federal Deposit Insurance Corporation (FDIC) Improvement Act of 1991 (FDICIA) and its implementing regulations and guidelines affect the engagements they perform. This section of the Audit Risk Alert synthesizes the requirements. Appendix A (paragraph .52) presents, verbatim, the regulations and guidelines that implement the law. Commentary prepared by the staff of the American Institute of Certified Public Accountants (AICPA) is included to focus on practical matters that the independent accountant should consider when taking action to comply with the requirements. The agreed-upon procedures that must be performed by the independent accountant, as presented in Appendix B (paragraph .53), are also reprinted verbatim with AICPA staff commentary. Both appendixes should be read in their entirety.

.02 Independent accountants serving covered institutions will be required—for the first time—to attest to managements' assertions about internal controls over financial reporting and compliance with laws and regulations. Independent accountants should become familiar with the new reporting requirements, particularly those that address the independent accountant's qualifications, exposure to enforcement actions, required communications with client institutions, and interaction with the audit committee. The effects of a number of the law's provisions on a client institution's ability to remain a going concern should also be considered.

.03 This document is not intended to provide comprehensive guidance on implementing the requirements of the law, regulations, and guidelines. This document does, however, focus on several practical matters concerning implementation that the independent accountant should consider in complying with the requirements. In a number of these areas, guidance has not yet been developed and the independent accountant will need to exercise judgment about how to proceed. For example, independent accountants will need to make judgments on practical matters such as the following:

- Performing agreed-upon procedures on internal auditors' workpapers
- Determining sample sizes for agreed-upon procedures
- Defining financial reporting controls
- Reporting on "safeguarding" objectives in the report on management's assertion about financial reporting controls

This Audit Risk Alert should not be substituted for a complete reading of the applicable sections of the law, regulations, and guidelines where appropriate.

The Law

.04 Early in 1991, Congress was informed that the FDIC's Bank Insurance Fund (BIF) would need more money because a record number of banks had failed, and that regulators needed timely information about the financial condition of banks. Legislative proposals coupling additional money for the BIF with an enhanced financial reporting system for federally insured depository institutions became the basis for a number of reforms embodied in the FDICIA. These measures reflect policymakers' emphasis on regulatory solutions to concerns about the depository institutions industry.

.05 Although related legislative proposals that would have expanded bank powers (by permitting interstate activities and new products and services) were ultimately dropped, the reach of the final provisions—which emphasize least-cost resolutions and improved supervision and examinations—surpasses even that of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA).

.06 Signed into law in December 1991, FDICIA spawned a rule making process that, when completed, will alter every major area of existing regulation of banks and thrifts. As discussed below, the effect of FDICIA on practice in the industry and on the current regulatory environment requires heightened awareness among practitioners.

.07 The federal banking regulatory agencies have been carrying out the massive effort necessary to develop regulations to implement the law, including audit provisions that directly affect CPAs. Many provisions of the FDICIA are amendments or additions to the Federal Deposit Insurance Act (FDI Act). Major provisions affecting practitioners who provide services to depository institutions are summarized below. Readers should refer to the law, implementing regulations, and guidelines for a complete discussion of these and other requirements.

The Implementing Regulations

Reporting Requirements—Section 36

.08 New Section 36 of the FDI Act (added by Section 112 of the FDICIA) creates new reporting requirements including, for the first time, reports by managements and independent accountants on internal controls over financial reporting and compliance with certain laws and regulations. It also establishes minimum qualifications for independent accountants serving the affected institutions. The Section 36 provisions, as summarized below, apply to each FDIC-insured depository institution having total assets of $500 million or greater at the beginning of its fiscal year. The reporting requirements are effective for fiscal years ending December 31, 1993, and thereafter. Despite the asset threshold, Section 36 does not override any non-FDICIA requirements for audited financial statements or other requirements that an institution exempt from Section 36 must otherwise satisfy.[1]

.09 To implement Section 36, the FDIC has issued both a final regulation[2] and accompanying guidelines and interpretations (guidelines), which became effective July 2, 1993. The general requirements are summarized below; however, the side-by-side analysis of the detailed regulation and guidelines presented in Appendix A (paragraph .52) should be read as an integral part of this Audit Risk Alert.

.10 *Annual Report.* Management is required to prepare, annually, a report that includes the following: [3]

- Financial statements prepared in conformity with generally accepted accounting principles (GAAP)
- A written assertion about the effectiveness at year-end of the institution's internal controls over financial reporting
- A written assertion about the institution's compliance during the year with (a) federal laws and regulations relative to insider loans, and (b) federal and state laws and regulations relative to dividend restrictions

Management must also include a statement about its responsibilities for the financial statements, financial reporting controls, and compliance with laws and regulations.

.11 Management must engage an independent accountant to provide the following reports annually:

- An audit report on the GAAP-basis financial statements

[1] In FDIC Financial Institution Letter (FIL-43-93), the FDIC noted that, in adopting the final rule implementing Section 36, the Board of Directors of the FDIC reiterated its belief that "every depository institution, regardless of size or charter, should voluntarily have an annual audit of its financial statements by an independent public accountant and establish an independent audit committee."

[2] The regulation and guidelines implementing FDI Act Section 36 (which have been reproduced in Appendix A [paragraph .52]) are codified in Section 12 of the Code of Federal Regulations (CFR) Part 363. The regulation was published in the *Federal Register* on June 2, 1993, and in FDIC FIL-41-93.

[3] The reporting requirements may be satisfied for certain subsidiaries through reporting by their holding companies. These exemptions are discussed in Section 363.1 of the rule and in guidelines 2-4.

- An examination-level attestation report on management's assertion about financial reporting controls

An agreed-upon procedures-level attestation report on management's assertion about compliance with insider loan and dividend restriction laws and regulations is also required, but is not included in the institution's annual report and, therefore, is not publicly available.

.12 The financial statement audit is to be performed in accordance with generally accepted auditing standards (GAAS). The examination of management's assertion about financial reporting controls and the agreed-upon procedures report on management's compliance assertion are to be performed in accordance with the AICPA's Statements on Standards for Attestation Engagements (SSAE).[4]

.13 The audited financial statements and other reports of management and the independent accountant must be filed with the FDIC and other regulatory agencies within the ninety days following the institution's fiscal year-end. Management must also file any management letter, qualification, or other report within fifteen days following receipt from the independent accountant.

.14 All of management's reports will be made publicly available. The independent accountant's report on the financial statements and attestation report on financial reporting controls will also be made publicly available. The independent accountant's agreed-upon procedures report and any management letter, while filed with the FDIC, will not be included in the annual report and, therefore, will not be publicly available.

.15 *Qualifications of Independent Accountants.* Acceptance of an engagement to report under Section 36 is conditioned on the independent accountant being enrolled in a practice-monitoring program. Membership in the AICPA Division for Firms' SEC Practice Section or Private Companies Practice Section, or enrollment in the AICPA's Quality Review Program will satisfy this requirement.

.16 Another condition of the engagement is that the independent accountant agree to provide regulators with access to workpapers related to the three engagement reports. Although this condition is not explicitly expressed in the law or regulations, the implementing guidelines also call for providing copies of workpapers to regulators. Independent accountants should read the July/August 1993 *Notice to Practitioners* (included as Appendix C (paragraph .54) to this Audit Risk Alert), which provides guidance on complying with requests for access to, and copies of, workpapers when required to do so by contract, law, or regulation.

.17 The accountant must meet the independence requirements and interpretations of the AICPA and the Securities and Exchange Commission (SEC) and its staff.

.18 The implementing regulation requires both management and independent accountants to provide certain notifications of changes in an institution's independent accountants within specified time periods. An independent accountant must also file a peer review report within fifteen days of acceptance of the report.

.19 *Enforcement Actions Against Accountants.* Section 36 of the FDI Act also provides for enforcement actions against accountants with respect to the Section 36 requirements. However, the regulatory agencies have not yet proposed or published rules or guidelines to implement this statutory requirement.[5]

.20 *Communication With Auditors.* Each subject institution must provide its independent accountant with copies of the institution's most recent reports of condition and examination; any supervisory memorandum of understanding or written agreement with any federal or state regulatory agency; and a report of any action initiated or taken by federal or state banking regulators.

[4] SSAE No. 2, *Reporting on an Entity's Internal Control Structure Over Financial Reporting* (AT section 400), was issued in June 1993. On April 7, 1993, the AICPA's Auditing Standards Board issued an exposure draft of a proposed SSAE, *Compliance Attestation*, which, when finalized, will provide additional guidance on compliance attestation engagements. A final statement is expected to be issued by year-end 1993.

[5] Section 36(g)(4) of the FDI Act states that the FDIC or the appropriate federal banking agency may "remove, suspend, or bar an independent public accountant, upon a showing of good cause, from performing audit services" required by Section 36. The federal banking agencies are expected to jointly issue rules to implement this provision.

.21 *Audit Committees.* Each subject institution must have an independent audit committee made up entirely of outside directors independent of management. One of the audit committee's required duties is to review with management and the independent accountant the reports required under Section 36. A list of other suggested duties is included in the guidelines, some of which relate to the independent accountant. Audit committees of institutions having $3 billion or more in assets must include members with banking or related financial management expertise, have access to their own outside counsel, and not include any large customers of the institution.

Accounting Reforms—Section 37

.22 FDI Act Section 37 was added by FDICIA Section 121 to establish accounting objectives, standards, and requirements for regulatory financial reporting, that is, the Federal Financial Institutions Examination Council (FFIEC) Consolidated Reports of Condition and Income (Call Reports) and Thrift Financial Reports (TFRs). Among other provisions, Section 37—

- Requires regulatory financial reporting to be uniform and consistent with GAAP, unless more stringent principles are considered necessary to reflect capital accurately, facilitate effective supervision, or permit prompt corrective action.
- Instructs the regulatory agencies to develop both a method for supplemental disclosures of market values of assets and liabilities (to the extent feasible and practicable) and regulations to ensure adequate reporting of off-balance-sheet transactions (including reporting of contingent assets and liabilities).
- Promotes uniformity of capital and accounting standards among the federal regulatory agencies.

.23 On April 13, 1993, the FFIEC requested comment on a proposed approach to unaudited supplemental fair value disclosures that would use concepts and principles set forth in the Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 107, *Disclosures about Fair Value of Financial Instruments* (AC F25). No other proposals have been made toward implementation of the Section 37 provisions.

Prompt Corrective Action—Section 38

.24 FDICIA makes capital an essential indicator to be used by regulators in monitoring the financial health of insured depository institutions. Regulatory intervention is focused primarily on an institution's capital levels relative to regulatory standards. Through FDI Act Section 38, FDICIA added a uniform framework for prompt corrective regulatory action to the existing capital adequacy guidelines set forth by each agency for safety and soundness purposes.[6]

.25 The independent accountant considers regulatory capital from the perspective that noncompliance or expected noncompliance with regulatory capital requirements may be a condition, when considered with other factors, that could indicate substantial doubt about an entity's ability to continue as a going concern. The AICPA's Statement on Auditing Standards (SAS) No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU section 341), provides guidance in this area.

.26 Capital regulations are complex and their application by management requires a thorough understanding of specific requirements and the potential impact of noncompliance. Accordingly, relevant regulations and regulatory guidance should be referred to by the independent accountant as necessary when considering regulatory capital matters.

.27 Effective December 19, 1992, Section 38 provides for supervisory action at certain institutions based on their capital levels. Each institution falls into one of five regulatory capital categories based primarily on three capital measures: Tier 1 leverage, total risk-based, and Tier 1 risk-based capital. These capital ratios are defined in

[6] The final rules implementing prompt corrective action were published in the September 29, 1992, *Federal Register;* in the FDIC's FIL-70-92; and in the Office of the Comptroller of the Currency's (OCC's) Banking Bulletin 92-52 and Banking Circular 268.

the same manner for Section 38 purposes as under the respective agencies' capital adequacy guidelines and regulations. For savings institutions, Tier 1 leverage capital is comparable to core capital, as defined.

.28 Regulations also specify a minimum requirement for tangible equity, which is defined as Tier 1 capital plus cumulative perpetual preferred stock, net of all intangibles except limited amounts of purchased mortgage servicing rights (PMSRs). In calculating the tangible equity ratio, intangibles (except for qualifying PMSRs) should also be deducted from the total assets included in the ratio denominator.

.29 An institution may be reclassified between certain capital categories if its condition or an activity is deemed by regulators to be "unsafe or unsound." A change in an institution's capital category initiates certain mandatory—and possibly additional discretionary—action by regulators.

.30 Under Section 38, an institution is considered—

- *Well capitalized* if its capital level significantly exceeds the required minimum level for each relevant capital category.
- *Adequately capitalized* if its capital level meets the minimum levels.
- *Undercapitalized* if its capital level fails to meet the minimum levels.
- *Significantly undercapitalized* if its capital level is significantly below the minimum levels.
- *Critically undercapitalized* if it has a ratio of tangible equity to total assets, as defined, of 2 percent or less, or otherwise fails to meet the critical capital level, as defined.

.31 The minimum levels are defined as shown in the following table:

Capital Category	*Total Risk-Based (Ratio)*	*Tier 1 Risk-Based (Ratio)*	*Tier 1 Leverage (Ratio)*
Well capitalized	≥ 10%	≥ 6%	≥ 5%
Adequately capitalized	≥ 8	≥ 4	≥ 4*
Undercapitalized	< 8	< 4	< 4*
Significantly undercapitalized	< 6	< 3	< 3

* 3.0 percent for 1-rated institutions under the regulatory CAMEL, MACRO, or related rating system.

.32 As noted in the preceding, critically undercapitalized institutions are those having a ratio of tangible equity to total assets of 2 percent or less.

.33 An institution will not be considered well capitalized if it is under a cease-and-desist order, formal agreement, capital directive, or prompt-corrective-action capital directive.

.34 Actions that may be taken under the prompt corrective action provisions range from the restriction or prohibition of certain activities, such as the payment of dividends, to the appointment of a receiver or conservator.

.35 Regulators will also require undercapitalized institutions to submit a plan for restoring the institution's capital to an acceptable level. For example, each undercapitalized institution is required to submit a plan that specifies the following:

- Steps the institution will take to become adequately capitalized
- Targeted capital levels for each year of the plan
- How the institution will comply with other restrictions or requirements put into effect
- The types and levels of activities in which the institution will engage

.36 Savings institutions that are complying with capital plans approved by the Office of Thrift Supervision (OTS) prior to December 19, 1991, are not required to file new plans and are not immediately subject to certain sanctions.

.37 Noncompliance or expected noncompliance with regulatory capital requirements may be a condition, when considered with other factors, that could indicate substantial doubt about an entity's ability to continue as a going concern. The implementation of the prompt corrective action provisions warrants similar attention by auditors when considering an institution's ability to remain a going concern.

Internal Control Standards—Section 39

.38 New Section 39 of the FDI Act (as added by Section 132 of the FDICIA) requires the federal banking agencies to prescribe safety and soundness standards for management and operation of insured depository institutions, including standards for internal controls. Implementing regulations will apply to all federally insured institutions and must be finalized by August 1, 1993, to become effective no later than December 31, 1993.

.39 In July 1992, the federal banking agencies jointly published an advance notice of proposed rule making for Section 39 (*Federal Register,* July 15, 1992). In April 1993, the Board of Governors of the Federal Reserve System (FRB) approved a staff proposal for implementation of Section 39. Because the federal banking agencies plan to simultaneously issue their proposals for comment, the FRB proposal was not immediately published for comment. However, the joint proposal is expected to track the FRB's draft.

.40 Among other matters, the FRB draft proposal would require state member banks to have internal controls and information systems that provide for the following:

(a) An organizational structure that establishes clear lines of authority and responsibility for monitoring adherence to prescribed policies

(b) Effective risk assessment

(c) Timely and accurate financial, operational, and regulatory reports

(d) Adequate procedures to safeguard and manage assets

(e) Compliance with applicable laws and regulations

.41 The Section 39 internal control requirements (as proposed in the FRB draft) would exceed the scope of the Section 36 management and independent accountant reports, which are limited to internal controls over financial reporting. Management is not required to make an assertion, nor is the independent accountant required to examine or report on any such management assertion, about the broader internal controls and information systems contemplated by Section 39.

.42 The Section 39 proposal also prescribes standards for operations, management, internal audit, asset quality, earnings, stock valuation, and employee compensation. If an institution fails to meet any of the prescribed standards, it must submit and implement a plan to achieve compliance. Failure to submit or implement the plan could lead to supervisory action.

Effects on Institutions' Liquidity

.43 Several provisions of FDICIA may affect the liquidity of an institution. Specifically, FDICIA places new restrictions on the following:

- Acceptance of brokered deposits by certain institutions[7]

[7] See FDICIA Section 301 and FDIC FIL-3-92.

- Availability of borrowings through the discount window[8]
- Exposure to the institution posed by transactions with correspondent banks and related limitations on interbank liabilities[9]

Accordingly, the independent accountant should consider whether the effect on the institution's liquidity, when considered with other factors, could indicate substantial doubt about an entity's ability to continue as a going concern.

Qualified-Thrift-Lender Test—Subtitle G

.44 To be considered a savings institution, an entity must hold a specific portion of its assets in eligible housing-related assets. On July 1, 1991, the required minimum percentage of qualified investments was 70 percent. Subtitle G of the FDICIA modified the qualified-thrift-lender (QTL) test to require that minimum qualified thrift investments equal or exceed 65 percent of assets, as defined, on a monthly average basis in nine out of every twelve months. Subtitle G also expands the definition of qualified thrift investments to include stock of any Federal Home Loan Bank, the Federal Home Loan Mortgage Corporation, and the Federal National Mortgage Association. The amounts of certain assets includable in the numerator and deductible in the denominator of the QTL ratio were also modified (see *Federal Register,* September 2, 1992).

.45 Noncompliance with the QTL requirement subjects an institution and its holding company, if any, to certain restrictions, among other regulatory actions. An institution that fails the OTS QTL test may also fail the separate Internal Revenue Service (IRS) QTL test.

Information Sources

.46 Copies of the FDICIA (stock number 869-015-00242-6) are available from the Government Printing Office (GPO). Call (202) 783-3238, or send an order via fax to (202) 512-2250 (VISA or MasterCard charges only; include expiration date). The price is $4.50.

.47 FDIC policy is communicated in Financial Institution Letters, News Releases, Regional Director Memoranda, updates to the Division of Supervision Manual of Examination Policies, and instructions for FFIEC Consolidated Reports of Condition and Income (Call Reports). For information about ordering these issuances, call FDIC Corporate Communications at (202) 898-6996.

.48 OCC supervisory policies and guidance are issued as Advisory Letters, Banking and Examining Bulletins and Circulars, Memoranda, News Releases, updates to the OCC Policies and Procedures Manual, the Bank Accounting Advisory Series, instructions for FFIEC Call Reports, and other issuances. For information on ordering copies of OCC issuances, call OCC Publications Control at (202) 874-4884.

.49 Information about FRB publications is available through FRB Publications Services at (202) 452-3245.

.50 OTS supervisory policies and guidance are issued in the form of Thrift Bulletins, Regulatory Bulletins, Transmittals, and in guidance provided to examiners through a multivolume set of agency handbooks. For information on ordering OTS publications, call the OTS Controller's Division at (202) 906-6427.

.51 The *Federal Register* contains notices about the actions of federal government agencies. It may be purchased from the GPO by calling (202) 783-3238 or by writing to New Orders, Superintendent of Documents, PO Box 371954, Pittsburgh, PA 15250-7954. Most public libraries also have copies of the *Federal Register.*

[The next page is 8409.]

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[8] See FDICIA Section 142.

[9] See FDICIA Section 308 and OCC Banking Bulletin 93-3.

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Appendix A

Audit and Reporting Requirements

Reprinted below are 12 CFR Part 363—Annual Independent Audits and Reporting Requirements (left column) and Appendix A to Part 363—Guidelines and Interpretations (center column). The regulation and appendix were published in the June 2, 1993 *Federal Register.* The right column is the AICPA staff's commentary on the regulation and guidelines.

Regulation

§ 363.1 SCOPE

(a) Applicability. This part applies with respect to fiscal years of insured depository institutions which begin after December 31, 1992. This part does not apply with respect to any fiscal year of any insured depository instituDHtion, the total assets of which, at the beginning of such fiscal year, are less than $500 million.

(b) Compliance by subsidiaries of holding companies. The audited financial statements requirement of § 363.2(a) may be satisfied for an insured depository institution that is a subsidiary of a holding company by audited financial statements of the consolidated holding company. The other requirements of this part for an insured depository institution that is a subsidiary of a holding company may be satisfied by the holding company if:

(1) The services and functions comparable to those required of the insured depository institution by this part are provided at the holding company level; and

(2) Either the insured depository institution has total assets as of the beginning of such fiscal year of:

(i) less than $5 billion; or

Guidelines

1. Measuring Total Assets. To determine whether this part applies, an institution should use total assets as reported on its most recent Report of Condition (Call Report) or Thrift Financial Report (TFR), the date of which coincides with the end of its preceding fiscal year. If its fiscal year ends on a date other than the end of a calendar quarter, it should use its Call Report or TFR for the quarter end immediately preceding the end of its fiscal year.

2. Insured Branches of Foreign Banks. Unlike other institutions, insured branches of foreign banks are not separately incorporated or capitalized. To determine whether this part applies, an insured branch should measure claims on non-related parties reported on its Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks (form FFIEC 002).

3. Compliance by Holding Company Subsidiaries. Audited consolidated financial statements and other reports or notices required by this part which are submitted by a holding company for any subsidiary institution, should be accompanied by a cover letter identifying all subsidiary institutions to which they pertain. An institution filing holding company consolidated financial statements as permitted by § 363.1(b) also may report on changes in its independent public accountant on a holding company basis. An institution that does not meet the criteria in section 36(i) must satisfy the remaining provisions of the statute and this part on an individual institution basis, and maintain its own audit committee. Multi-tiered holding companies may satisfy all requirements of this part at any level.

Commentary

- The requirements for independent accountants apply only to accountants serving the subject institutions. If an institution does not fall within the scope of § 363, neither the institution nor its independent accountant is subject to the rule or guidelines.

Regulation

(ii) more than $5 billion, but less than $9 billion, and a composite CAMEL (or MACRO, or equivalent) rating of 1 or 2.

Guidelines

4. Comparable Services and Functions. Services and functions will be considered "comparable" to those required by this part if the holding company:

(a) Prepares reports used by the subsidiary institution to meet the requirements of this part;

(b) Has an audit committee that meets the requirements of the part appropriate to its largest subsidiary institution; and

(c) Prepares and submits the management assessments of the effectiveness of the internal control structure and procedures for financial reporting ("internal controls"), and compliance with the Designated Laws defined in Guideline 12 that are based on information concerning the activities and operations of all subsidiary institutions within the scope of this part.

Commentary

- The guidelines use *internal controls* throughout to refer internal controls over financial reporting. Management and independent accountant reports required by the rule relate only to financial reporting controls—including *safeguarding of assets* as discussed in Guideline 9. These controls do *not* extend to compliance with applicable federal, state, and local laws and regulations *(compliance controls)* or controls over effectiveness and efficiency of operations *(operational controls).*
- See the related commentary on Guideline 8. Further guidance is needed on how the independent accountant would report (under SSAE No. 2, *Reporting on an Entity's Internal Control Structure Over Financial Reporting* [AT section 400]) when management applies Guideline 4(c) by making an assertion about the financial reporting controls of more than one of its subsidiary institutions within the scope of 12 Code of Federal Regulations (CFR) 363 *(a covered subsidiary).*
- In applying Guideline 4(c) to performance of the compliance attestation procedures, if the independent accountant performs procedures listed in Section I of Appendix B (paragraph .53) of this Audit Risk Alert, he or she could use sample sizes calculated on a consolidated basis for the holding company and all covered subsidiaries of that holding company. Sample sizes for covered subsidiaries that are not being reported on following Guideline 4(c) should not be calculated on a conHsolidated basis.

§ 363.2 ANNUAL REPORTING REQUIREMENTS

(a) Audited financial statements. Each insured depository institution shall prepare annual financial statements in accordance with generally accepted accounting principles which shall be audited by an independent public accountant.

5. Annual Financial Statements. Each institution should prepare comparative annual consolidated financial statements (balance sheets, statements of income, changes in equity capital, and cash flows, with accompanying footnote disclosures) in accordance with generally accepted accounting principles (GAAP) for each of its two most recent fiscal years. Statements for the earlier year may be presented on an unaudited basis if the institution was not subject to this part for that year and audited statements were not prepared.

Regulation	Guidelines	Commentary
	6. Holding Company Statements. Subsidiary institutions may file copies of their holding company's audited financial statements filed with the Securities and Exchange Commission (SEC) or prepared for their FR Y-6 Annual Report under the Bank Holding Company Act of 1956.	
	7. Insured Branches of Foreign Banks. An insured branch of a foreign bank should satisfy the financial statements requirement by filing one of the following for the two preceding fiscal years: (a) Audited balance sheets, disclosing information about financial instruments with off-balance-sheet risk; (b) Schedules RAL and L of Form FFIEC 002, prepared and audited on the basis of the instructions for its preparation; or (c) With written approval of the appropriate federal banking agency, consolidated financial statements of the parent bank.	● The guidelines permit insured branches of foreign banks to satisfy the requirement with (a) a balance sheet prepared in conformity with United States GAAP; (b) a schedule prepared on another comprehensive basis of accounting defined in the Federal Financial Institutions Examination Council (FFIEC) Consolidated Reports on Condition and Income (Call Reports) or Thrift Financial Reports (TFRs) instructions; or (c) the parent bank's consolidated financial statements, which may be prepared on a basis other than United States generally accepted accounting principles (GAAP).
(b) Management report. Each insured depository institution annually shall prepare, as of the end of the institution's most recent fiscal year, a management report signed by its chief executive officer and chief accounting or chief financial officer which contains: *(1) A statement of management's responsibilities for preparing the institution's annual financial statements, for establishing and maintaining an adequate internal control structure and procedures for financial reporting, and for complying with laws and regulations relating to safety and soundness which are designated by the FDIC and the appropriate federal banking agency; and* *(2) Assessments by management of the effectiveness of such internal control structure and procedures as of the end of such fiscal year and the institution's compliance with such laws and regulations during such fiscal year.*	8. Management Report. Management should perform its own investigation and review of the effectiveness of internal controls and compliance with Designated Laws defined in guideline 12. Management also should maintain records of its determinations and assessments until the next federal safety and soundness examination, or such later date as specified by the FDIC or appropriate federal banking agency. Management should provide in its assessment of the effectiveness of internal controls and compliance with the Designated Laws, or supplementally, sufficient information to enable the accountant to report on its assertions. The management report of an insured branch of a foreign bank should be signed by the branch's managing official if the branch does not have a chief executive or financial officer.	● The Statement on Standards for Attestation Engagements (SSAE) No. 2 (AT section 400) states "an entity's internal control structure over financial reporting includes those policies and procedures that pertain to an entity's ability to record, process, summarize, and report financial data consistent with the assertions embodied in either annual financial statements or interim financial statements, or both" (paragraph 2 [AT section 400.02]). Accordingly, management's assertion and the independent accountant's report should relate to the assertions embodied in the annual financial statements required by 12 CFR § 363.2(a). The federal banking agencies have not issued guidance about whether Call Reports or TFRs fall within the scope of management's assertion and the independent accountant's report. Call Reports and TFRs are not included in the annual report required by 12 CFR § 363.4(1). However, the FDIC staff has stated that management's assertion will be expected to address call reporting. ● Guideline 8 supports the concept in the exposure draft of the proposed SSAE, *Compliance Attestation,* issued by the AICPA's Auditing Standards Board on April 7, 1993, that management's assertion be specific enough to be capable of evaluation.

Regulation	Guidelines	Commentary
		● There are projects underway at various banking industry associations to provide guidance on management reporting.
	9. Safeguarding of Assets. The FDIC believes "safeguarding of assets," as the term relates to internal controls policies and procedures regarding financial reporting, and which has precedent in accounting literature, should be addressed in the management report and the independent public accountant's attestation discussed in guideline 18. It also believes that testing the existence of and compliance with internal controls on the management of assets, including loan underwriting and documentation, represents a reasonable implementation of section 36. Management should therefore address such internal controls as part of its management report, and the accountant should test compliance with them. Recognizing the lack of objective criteria against which the accountant may judge safeguarding of assets, however, the FDIC does not require the accountant to attest to the adequacy of safeguards, but only to determine whether safeguarding policies exist, and whether management has implemented them.[1]	● SSAE No. 2 (AT section 400) addresses "safeguarding of assets" as required by Guideline 9.* Management's assertion about, and the independent accountant's tests of, financial reporting controls will consider "safeguarding of assets" policies and procedures accordingly. The independent accountant's tests of controls over financial reporting of loans, for example, should include tests of whether the institution is executing transactions in accordance with management's policies for loan underwriting and loan documentation. Such procedures might include, for example, comparing approvals for loan transactions to management's written policy to ascertain whether the loan was apHproved by an officer or committee consistent with the authority limits specified for that officer or committee in the policy. Therefore, such policies and procedures are implicit in management's assertion and the independent accountant's opinion. However, management's assertion and the independent accountant's opinion could explicitly refer to safeguarding of assets, to emphasize that the scope of management's assertion and the attestation report is consistent with, and limited to, safeguarding of assets in the context discussed in paragraph 27 of SSAE No. 2 (AT section 400.27). Further guidance on such report language is needed.

[1] It is management's responsibility to establish underwriting policies and to make credit decisions. The auditor's role is to test compliance with management's policies.

* Specifically, paragraph 27 of SSAE No. 2 (AT section 400.27) states:

> In the context of an entity's internal control structure, safeguarding of assets refers only to protection against loss from errors and irregularities in the processing of transactions and the handling of related assets. It does not include, for example, loss of assets arising from management's operating decisions, such as selling a product that proves to be unprofitable, incurring expenditures for equipment or material that proves to be unnecessary or unsatisfactory, authorizing what proves to be unproductive research or ineffective advertising, or accepting some level of merchandise pilferage by customers as part of operating a retail business.

See also Appendix D of SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AU section 319.69).

Regulation	Guidelines	Commentary
		If the scope of management's assertion with respect to safeguarding of assets goes beyond the context discussed in paragraph 27 of SSAE No. 2 (AT section 400.27), management should explicitly describe the scope of its assertion and further guidance would be needed for reporting by the independent accountant.
	10. Standards for Internal Controls. Each institution should determine its own standards for establishing, maintaining and assessing the effectiveness of its internal controls.[2]	• SSAE No. 2 (AT section 400.27) establishes conditions for the acceptance of engagements to examine and attest to management assertions about financial reporting controls. One condition is that management evaluate the effectiveness of the institution's financial reporting controls using reasonable criteria for effective internal control structures established by a recognized body. Criteria issued by the AICPA, regulatory agencies, or other bodies that comprise experts who follow due procedures, including procedures for the broad distribution of proposed criteria for public comment, usually should be considered reasonable criteria for this purpose. For example, the report *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission provides reasonable criteria. The Auditing Standards Board has a project under way to conform SAS No. 55 (AU section 319) to the COSO report. SAS No. 30, *Reporting on Internal Accounting Control,* has been superseded by SSAE No. 2 (AT section 400).

[2] In considering what information is needed on safeguarding of assets and standards for internal controls, management may review guidelines provided by its primary federal regulator; the Federal Financial Institutions Examination Council's "Supervisory Policy Statement on Securities Activities"; the FDIC's "Statement of Policy Providing Guidance on External Auditing Procedures for State Nonmember Banks" (Jan. 16, 1990), "Statement of Policy Regarding Independent External Auditing Programs of State Nonmember Banks" (Nov. 16, 1988), and Division of Supervision Manual of Examination Policies; the Federal Reserve Board's Commercial Bank Examination Manual and other relevant regulations; the Office of Thrift Supervision's Thrift Activities Handbook; the Comptroller of the Currency's Handbook for National Bank Examiners; standards published by professional accounting organizations, such as the American Institute of Certified Public Accountant's (AICPA) Statement on Auditing Standards No. 30, "Reporting on Internal Accounting Control"; and other internal control standards published by the AICPA, other accounting or auditing professional associations, and financial institution trade associations.

Regulation	*Guidelines*	*Commentary*
	11. Service Organizations. Although service organizations should be considered in determining if internal controls are adequate, an institution's independent public accountant, its management, and its audit committee should exercise independent judgment concerning that determination. On-site reviews of service organizations may not be necessary to prepare the reports required by the Rule, and the FDIC does not intend that the Rule establish any such requirement.	● SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AU section 324), which provides guidance to independent accountants of a service organization on issuing a report on certain aspects of the service organization's internal control structure that can be used by other independent accountants, also provides guidance on how other independent accountants should use such reports. Further, paragraphs 84-87 of SSAE No. 2 (AT section 400.84—.87) discuss the relationship of the practitioner's examination of an entity's internal control structure to the opinion obtained in an audit of financial statements.
	12. Compliance with Laws and Regulations. The designated laws and regulations are the federal laws and regulations concerning loans to insiders and the federal and state laws and regulations concerning dividend restrictions, which are more specifically identified in Section I of the Agreed Upon Procedures referred to in guideline 19	

Regulation	Guidelines	Commentary

§ 363.3 INDEPENDENT PUBLIC ACCOUNTANT

(a) Annual audit of financial statements. Each insured depository institution shall engage an independent public accountant to audit and report on its annual financial statements in accordance with generally accepted auditing standards and section 37 of the Federal Deposit Insurance Act (12 U.S.C. 1831n). The scope of the audit engagement shall be sufficient to permit such accountant to determine and report whether the financial statements are presented fairly and in accordance with generally accepted accounting principles.

13. General Qualifications. To provide audit and attest services to insured depository institutions, an independent public accountant should be registered or licensed to practice as a public accountant, and be in good standing, under the laws of the state or other political subdivision of the United States in which the home office of the institution (or the insured branch of a foreign bank) is located. As required by section 36(g)(3)(A)(i), the accountant must agree to provide copies of any workpapers, policies, and procedures relating to services performed under this part.

- If the independent public accountant is a firm, the firm and the signing partner should meet qualification criteria.
- Practitioners should consult the AICPA Auditing Standards Division's *Notice to Practitioners* (reproduced as Appendix C (paragraph .54) to this document) for further guidance on complying with requests for access to workpapers.

With respect to requests for access, the independent accountant should consider asking that the regulators' request be in writing (as discussed in the *Notice to Practitioners*) and specify the documents sought and the reason for requesting access. The independent accountant should also consider asking that the request be signed by the highest official responsible for examinations at a state banking regulatory agency or the regional office of a federal regulatory agency. Further, the independent accountant should consider asking that the request acknowledge that the agency requesting access will keep any information obtained from the documents confidential. Agencies with access should be permitted to disclose such information if it is to be used as evidence in a formal proceeding brought by, or on behalf of, the agency against the client or the independent accountant, but only after the independent accountant and the client have received reasonable notice of the proposed disclosure and the opportunity to apply for an effective protective order.

14. Independence. The independent public accountant also should be in compliance with the AICPA's *Code of Professional Conduct* and meet the independence requirements and interpretations of the SEC and its staff.

- Under Guideline 14, independent accountants not currently subject to the Securities and Exchange Commission's (SEC's) independence requirements must meet those requirements.

15. Peer Reviews. As required by section 36(g) (3)(A)(ii), the independent public accountant must have received, or be enrolled in, a peer review that meets acceptable guidelines. The following peer review guidelines are acceptable:

(a) The external peer review should be conducted by an organization independent of the accountant or firm being reviewed, as frequently as is consistent with professional accounting practices;

(b) The peer review should be gener-

- Guideline 15 acknowledges that certain firms—for example, those that have been recently formed—may be enrolled in a practice monitoring program but may not have yet received a review. It also recognizes that certain firms may not have previously performed audits of depository institution financial statements.
- Current practice, as referred to by Guideline 15(a), requires a review once every three years.
- Guidance on making workpapers available to the FDIC in a form consistent with the SEC's agreement, as

Regulation	Guidelines	Commentary
	ally consistent with AICPA standards; [3] and (c) The review should include, if available, at least one audit of an insured depository institution or consolidated financial holding company. Peer review working papers are to be retained for 120 days after the peer review report is filed with the FDIC, and be made available to the FDIC upon request, in a form consistent with the SEC's agreement with the accounting profession.	referred to by Guideline 15(c), is available from the AICPA's Quality Review Division to independent accountants who receive such a request from the FDIC. ● Based on footnote 3 to Guideline 15, membership in the AICPA's Division for CPA Firms' SEC Practice Section or Private Companies Practice Section or enrollment in the AICPA Quality Review Program should satisfy the requirement.
	16. Filing Peer Review Reports. Within 15 days of receiving notification that the peer review has been accepted, or before commencing any audit under this part, whichever is earlier, two copies of the peer review report, accompanied by any letter of comments and letter of response, should be filed by the independent public accountant with the FDIC, Registration and Disclosure Section, 550 17th Street, NW, Washington, DC 20429, where they will be available for public inspection. Accountants may elect to file an annual list of their insured depository institution and holding company (identifying any subsidiary institutions subject to this part) audit clients in lieu of copies of peer review reports for each institution they have been engaged to audit. The FDIC has determined that such client lists are exempt from public disclosure. All corrective action required under any qualified peer review report should have been taken prior to commencing services under this part.	● Consistent with Guideline 15, a firm that is enrolled in a practice monitoring program, but has not yet received a report, would not be required to file a report before commencing an engagement under the rule. Independent accountants who are not currently undergoing a review in 1993 may wish to consider filing their most recent report with the FDIC now.

[3] These would include Standards for Performing and Reporting on Peer Reviews, codified in the *SEC Practice Section Reference Manual;* Standards for Performing and Reporting on Quality Reviews (QR section 100); or Standards for Performing and Reporting on Peer Reviews, of the AICPA's Private Companies Practice Section.

Regulation | *Guidelines* | *Commentary*

17. Information to Independent Public Accountant. Attention is directed to section 36(h) which requires institutions to provide specified information to their accountants. An institution also should provide its accountant with copies of any notice that the institution's capital category is being changed or reclassified under section 38 of the correspondence from the FDI Act, and any appropriate federal banking agency concerning compliance with this part.

- Section 36(h) referred to by Guideline 17 requires an institution to generally provide its independent accountant with copies of the following:
—The institution's most recent Call Report (or TFR) and report of examination
—Any supervisory memorandum of understanding and any written agreement between the institution and any federal or state banking agency
—A report of any action initiated or taken by federal or state banking agencies
—A report of any assessment of any civil money penalty under any other provision of law with respect to the institution or any institution-affiliated party.

(b) Additional reports. Such independent public accountant shall examine, attest to, and report separately on, the assertions of management concerning the institution's internal control structure and procedures for financial reporting. The accountant shall apply procedures agreed upon by the FDIC objectively to determine compliance by an insured depository institution with designated laws and regulations. The attestations shall be made in accordance with generally accepted standards for attestation engagements.

18. Attestation Reports. The independent public accountant should provide the institution with an internal controls attestation report, a compliance with Designated Laws attestation report, and any management letter, at the conclusion of the audit as required by section 36(c)(1). If a holding company subsidiary relies on its holding company management report, the accountant may attest to and report on the management's assertions in one report, without reporting separately on each subsidiary covered by this part. One attestation report for compliance with the Designated Laws also may be filed, if all exceptions are listed and the respective institutions to which the exceptions apply are identified. The FDIC has determined that management letters and the Designated Laws attestation report are exempt from public disclosure.

- Practitioners should consult SSAE No. 2 (AT section 400), and the final SSAE on compliance attestation that is expected to be issued by the AICPA by year-end 1993, for guidance on reporting that involves multiple locations.
- The independent accountant's compliance attestation report and any management letter will not be publicly available.

Regulation	*Guidelines*	*Commentary*
	19. Procedures for Determining Compliance with Designated Laws. In order to permit the independent public accountant to determine the extent of compliance with the Designated Laws defined in guideline 12 and the related assessment by management, the procedures set forth in schedule A (the Agreed Upon Procedures) to these Guidelines should be applied. The accountant should require all management representations to be in writing, and take appropriate steps to determine that any sampling is reasonably representative. Attestation reports generally should identify all findings from application of the Agreed Upon Procedures which establish any items of non-compliance, note any absence of written policies, and disclose the reasons why any Agreed Upon Procedures were not performed.	● Although Guideline 19 refers to a determination about compliance with laws and regulations, the independent accountant will make no such determination. Rather, the independent accountant will report procedures performed and findings. The FDIC and other regulatory agencies will have to consider the procedures and findings in making their own determination about compliance. ● The AICPA's SSAEs provide guidance on reporting findings, and scope limitations.
	20. Reviews with Audit Committee and Management. The independent public accountant should meet with the institution's audit committee to review the accountant's reports required by this part before they are filed. It also may be appropriate for the accountant to review its findings with the institution's board of directors and management.	
(c) Notice by accountant of termination of services. An independent public accountant performing an audit under this part who ceases to be the accountant for an insured depository institution shall notify the FDIC and the appropriate federal banking agency in writing of such termination within 15 days after the occurrence of such event, and set forth in reasonable detail the reasons for such termination.	21. Notice of Termination. The notice required by § 363.3(c) should state whether the independent accountant agrees with the assertions contained in any notice filed by the institution under § 363.4(d), and whether the institution's notice discloses all relevant reasons.	

Regulation	*Guidelines*	*Commentary*
	22. Reliance on Internal Auditors. Nothing in this part or this appendix is intended to preclude the ability of the independent public accountant to rely on the work of an institution's internal auditor.	● The extent to which the independent accountant may consider the work of internal auditors in a financial statement audit is addressed in SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AU section 322). SSAE No. 2 (AT section 400) refers the accountant to SAS No. 65 (AU section 322) when addressing the competence and objectivity of internal auditors; the nature, timing, and extent of work to be performed; and other related matters in an examination-level attestation engagement (such as a report on the examination of management's assertion about financial reporting controls). With respect to the compliance attestation engagement, the Auditing Standards Board, at its December 1992 meeting, concluded that the external auditor may not use the internal auditor for direct assistance in an agreed-upon procedures engagement to satisfy the FDICIA requirement. As discussed in appendix B (paragraph .53), guidance is needed for reporting on procedures performed on internal auditors' workpapers.

§ 363.4 FILING AND NOTICE REQUIREMENTS

Regulation	*Guidelines*	*Commentary*
(a) Annual reporting. Within 90 days after the end of its fiscal year, each insured depository institution shall file with each of the FDIC, the appropriate federal banking agency, and any appropriate state bank supervisor, two copies of: *(1) An annual report containing audited annual financial statements, the independent public accountant's report thereon, management's statements and assessments, and the independent public accountant's attestation report concerning the institution's internal control structure and procedures for financial reporting as required by § 363.2(a) and 363.3(a), and 363.3(b) respectively; and* *(2) the accountant's attestation concerning compliance with laws and regulations pursuant to § 363.3(b).*	23. Place for Filing. Except for peer review reports filed pursuant to Guideline 16, all reports and notices required by, and other communications or requests made pursuant to, this part should be filed as follows: (a) FDIC: Regional Director (Supervision) of the FDIC Regional Office in which the institution is headquartered; (b) Office of the Comptroller of the Currency (OCC): appropriate OCC Supervisory Office; (c) Federal Reserve: appropriate Federal Reserve Bank; (d) Office of Thrift Supervision (OTS): appropriate OTS District Office; and (e) State bank supervisor: the filing office of the appropriate state bank supervisor.	

Regulation	Guidelines	Commentary
	24. Relief from Filing Deadlines. Although the FDIC believes that the deadlines for filings and other notices established by section 36 and this part are reasonable, it recognizes some institutions occasionally may be confronted with extraordinary circumstances beyond their reasonable control that may justify extensions of a deadline. In that event, upon written application from an insured depository institution, setting forth the reasons for any requested extension, the FDIC or appropriate federal banking agency may, for good cause shown, extend the deadline for a period not to exceed 30 days.	
(b) Public availability. The foregoing annual report in paragraph (a) of this section shall be available for public inspection.	25. Public availability. Each institution's annual report should be available for public inspection at its main branch offices no later than 15 days after it is filed with the FDIC. Alternatively, an institution may elect to mail one copy of its annual report to any person who requests it. The annual report should remain available to the public until the annual report for the next year is available. An institution may use its annual report under this part to meet the annual disclosure statement required by 12 CFR 350.3, if the institution satisfies all other requirements of 12 CFR part 350.	● The publicly available annual report contains the independent accountant's audit report on financial statements and attestation report on management's assertion about financial reporting controls. The independent accountant's agreed-upon procedures report is not to be included in the annual report and is not publicly available.
(c) Independent accountant's reports. Each insured depository institution shall file with the FDIC, the appropriate federal banking agency, and any appropriate state bank supervisor, a copy of any management letter, qualification, or other report issued by its independent public accountant with respect to such institution and the services provided by such accountant pursuant to this part within 15 days after receipt.	26. Independent Public Accountant's Report. Section 36(h)(2)(A) requires that, within 15 days of receipt by an institution of any management letter or other report, such letter or other report shall be filed with the FDIC, any appropriate federal banking agency and any appropriate state bank supervisor. Institutions and their accountants are encouraged to coordinate preparation and delivery of audit and attestation reports and filing the annual report, to avoid duplicate filings.	● Note that management must file, within fifteen days of receipt, reports of the independent accountant, even if they will be filed later with the annual report discussed in Guidelines 23 and 25. For example, if management receives a letter communicating internal control structure matters noted in the interim fieldwork for a subject finanDHcial statement audit, that report should be filed when received. SAS No. 1, *Codification of Auditing Standards and Procedures* (AU section 530), provides guidance on dating of the independent auditor's report on financial statements. When providing final reports, practitioners may wish to include a transmittal letter, which will help document when the report was sent to the institution. ● The law, implementing regulations, and guidelines do not eliminate the independent accountant's responsibility under generally accepted auditing standards (GAAS) for communicating internal control structure related matters noted in a financial statement audit.

Regulation	*Guidelines*	*Commentary*
		● "Other report" refers to the reports required by 12 CFR § 363.
(d) Notice of engagement or change of accountants. Each insured depository institution shall provide, within 15 days after the occurrence of any such event, written notice to the FDIC, the appropriate federal banking agency, and any appropriate state bank supervisor of the engagement of an independent public accountant, or the resignation or dismissal of the independent public accountant previously engaged. The notice shall include a statement of the reasons for any such event in reasonable detail.	27. Notices Concerning Accountants. Institutions should review and satisfy themselves as to compliance with the required qualifications set forth in guidelines 13-15 before engaging an independent public accountant. With respect to any selection, change or termination of an accountant, institutions should be familiar with the notice requirements in guideline 21, and should send a copy of any notice under § 363.4(d) to the accountant when it is filed with the FDIC. An institution which files reports with its appropriate federal banking agency under, or is a subsidiary of a holding company which files reports with the SEC pursuant to, the Securities Exchange Act of 1934 may use its current report (e.g. SEC Form 8-K) concerning a change in accountant to satisfy the similar notice requirements of this part.	● The current report filed with regulators (that is, Form F-3 for the FDIC and SEC Form 8-K for others) includes the independent accountant's response to management's disclosures. However, it may not include all matters required to be reported under 12 CFR § 363.3(c) and Guideline 21.
§ 363.5 AUDIT COMMITTEES		
(a) Composition and duties. Each insured depository institution shall establish an independent audit committee of its board of directors, the members of which shall be outside directors who are independent of management of the institution, and the duties of which shall include reviewing with management and the independent public accountant the basis for the reports issued under this part.	28. Composition. The board of directors of each institution should determine if outside directors meet the requirements of section 36 and this part. At least annually, it should determine whether all existing and potential audit committee members are "independent of management of the institution." If the institution has total assets in excess of $3 billion, the board also should determine whether members of the committee satisfy the additional requirements of this part. Because an insured branch of a foreign bank does not have a separate board of directors, the FDIC will not apply the audit committee requirements to such branch. However, any such branch is encouraged to make a reasonable good faith effort to see that similar duties are performed by persons whose experience is generally consistent with the Rule's requirements for an institution the size of the insured branch. 29. "Independent of Management" Considerations. In determining whether an outside director is independent of management, the board should consider all relevant information. This would include considering whether the director: (a) Is or has been an officer or employee of the institution or its affiliates;	

Regulation	Guidelines	Commentary

(b) Serves or served as a consultant, advisor, promoter, underwriter, legal counsel, or trustee of or to the institution or its affiliates;

(c) Is a relative of an officer or other employee of the institution or its affiliates;

(d) Holds or controls a direct or indirect financial interest in the institution or its affiliates; and

(e) Has outstanding extension of credit from the institution or its affiliates.

30. Lack of Independence. An outside director should not be considered independent of management if such director is, or has been within the preceding year, an officer or employee of the institution or any affiliate, or owns or controls, or has owned or controlled with the preceding year, assets representing 10 percent or more of any outstanding class of voting securities of the institution.

31. Holding Company Audit Committees. Members of an independent audit committee of a holding company may serve as the audit committee of any subsidiary institution if they are otherwise independent of management of the subsidiary. This would not, however, permit officers or employees of the holding company to serve on the audit committee of its subsidiary institutions. The audit committee of the holding company may perform all the duties of the audit committee of a subsidiary institution, even though such holding company directors are not directors of the institution.

32. Duties. The audit committee should perform all duties determined by the institution's board of directors. The duties should be appropriate to the size of the institution and the complexity of its operations, and include reviewing with management and the independent public accountant the basis for the reports issued under § 363.2(b). Appropriate additional duties could include:

(a) Reviewing with management and the independent public accountant the scope of services required by the audit, significant accounting policies, and audit conclusions regarding significant accounting estimates;

Regulation	Guidelines	Commentary
	(b) Reviewing with management and the accountant their assessments of the adequacy of internal controls, and the resolution of identified material weaknesses and reportable conditions in internal controls, including the prevention or detection of management override or compromise of the internal control system; (c) Reviewing with management and the accountant the institution's compliance with laws and regulations; (d) Discussing with management the selection and termination of the accountant and any significant disagreements between the accountant and management; and (e) Overseeing the internal audit function. It is recommended that audit committees maintain minutes and other relevant records of their meetings and decisions.	
(b) <u>Committees of large institutions.</u> The audit committee of any insured depository institution that has total assets of more than $3 billion, measured as of the beginning of each fiscal year, shall include members with banking or related financial management expertise, have access to its own outside counsel, and not include any large customers of the institution.	33. <u>Banking or Related Financial Management Expertise.</u> At least two members of the audit committee of a large institution shall have "banking or related financial management expertise" as required by section 36(g)(1)(C)(i). This determination is to be made by the board of directors of the insured depository institution. A person will be considered to have such required expertise if the person has significant executive, professional, educational, or regulatory experience in financial, auditing, accounting, or banking matters as determined by the board of directors. Significant experience as an officer or member of the board of directors or audit committee of a financial services company would satisfy these criteria. 34. <u>Large Customers.</u> Any individual or entity (including a controlling person of any such entity) which, in the determination of the board of directors, has such significant direct or indirect credit or other relationships with the institution, the termination of which likely would materially and adversely affect the institution's financial condition or results of operations, should be considered a "large customer" for purposes of § 363.5(b).	

Regulation	Guidelines	Commentary
	35. Access to Counsel. The audit committee should be able to retain counsel at its discretion without prior permission of the institution's board of directors or its management. Section 36 does not preclude advice from the institution's internal counsel or regular outside counsel. It also does not require retaining or consulting counsel, but if the committee elects to do either, it also may elect to consider issues affecting the counsel's independence. Such issues would include whether to retain or consult only counsel not concurrently representing the institution or any affiliate, and whether to place limitations on any counsel representing the institution concerning matters in which such counsel previously participated personally and substantially as outside counsel to the committee.	
	36. Forming and Restructuring Audit Committees. Audit committees should be formed within four months of the effective date of this part. Some institutions may have to restructure existing audit committees to comply with this part. No regulatory action will be taken if institutions restructure their audit committees by the earlier of their next annual meeting of stockholders, or one year from the effective date of this part.	
	37. Modifications of Guidelines. The FDIC Board of Directors has delegated to the Director of the FDIC's Division of Supervision authority to make and publish in the *Federal Register* minor technical amendments to the Guidelines (including the attached Agreed Upon Procedures in schedule A to this appendix), in consultation with the other appropriate federal banking agencies, to reflect the implementation of this part. It is not anticipated any such modification would be effective until affected institutions have been given reasonable advance notice of the modification. Any material modification or amendment will be subject to review and approval of the FDIC Board of Directors.	

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Appendix B

Agreed-Upon Procedures

Reprinted in the following are the agreed-upon procedures to be performed by the independent accountant in relation to management's assertion about compliance with dividend restriction and insider loan laws and regulations.[1] The resulting report will not be publicly available (see guideline 18 in appendix A [paragraph .52]). The AICPA staff commentary on the procedures is provided in the fully italicized paragraphs.

Section I—Procedures for Individual Institutions

The following information should be obtained, and the indicated procedures should be performed, by the institution's independent public accountant in accordance with generally accepted standards for attestation engagements, or by the institution's internal auditor if the procedures set forth in section II of this schedule are to be performed by the accountant.

> ***Commentary:*** *On April 7, 1993, the Auditing Standards Board published an exposure draft of a proposed Statement on Standards for Attestation Engagements (SSAE),* Compliance Attestation. *That statement would provide additional guidance on such agreed-upon procedures level attestation engagements. Comments on the exposure draft were due by June 30, 1993. A final statement is expected to be issued by year-end 1993.*

> ***Commentary:*** *The following sample sizes have not been objected to by the FDIC, the OCC, or the OTS for purposes of applying those procedures that require sampling:*

Population Number (N)	*Sample size*
100 or greater	60
50 to 100	25
0 to 50	N or 20, whichever is smaller

A. Loans to Insiders

1. *Designated Laws.* The following laws and regulations (Designated Insider Laws) should be read:

(a) The laws codified at 12 U.S.C. 375, 375a, 375b, 376, 1468(b), 1828(j)(2), 1828(j)(3)(B), 1817(k), and 1972; and

(b) The regulations set forth at 12 CFR 23.5, part 31, 211.3(b)(4), part 215, 337.3, 349.3, 563.43, and 935.2.

2. *Information and Procedures.* Obtain from management of the institution, and read, the following information for the institution's most recent fiscal year through the date of the attestation report, and perform the procedures indicated with respect to such information:

a. *General Information.* Obtain management's assessment of compliance with the Designated Insider Laws; all minutes (including minutes drafted, but not approved) of the meetings of the board and its committees; reports of examinations, supervisory agreements, and enforcement actions issued by the institution's primary federal and state regulators, if applicable; all public documents filed under the Securities and Exchange Act of 1934 with the FDIC, SEC, Federal Reserve Board, OCC, or OTS and annual reports filed by insiders identifying their related interest as required by 12 CFR 215.7.

Procedure:

(i) Read the foregoing information.

[1] Reprinted from Appendix A to 12 CFR Part 363. See *Federal Register,* June 2, 1993.

(ii) Trace and agree each disclosed insider loan and other extension of credit to see that it is included on the list of Insider Transactions.

b. *Calculations.* Obtain management's calculation of the greater of 5 percent of the institution's year-end capital and unimpaired surplus or $25,000.

Procedure: Recalculate for mathematical accuracy, and trace amounts used in management's calculations to the institution's year-end Call Report or TFR.

c. *Policies and Procedures.* Obtain the institution's written policies and procedures concerning its compliance with the Designated Insider Laws, including any written "Code of Ethics" or "Conflict of Interest" policy statements. If the institution has no written policies and procedures, obtain a narrative from management that describes the methods for complying with such laws, and includes provisions similar to those listed below.

Procedure: Ascertain that the policies and procedures include, or incorporate by reference, provisions consistent with the Designated Insider Laws for:

(i) Defining terms;

(ii) Prohibiting and restricting loans to insiders (i.e., directors, executive officers, and principal shareholders and their related interests);

(iii) Maintaining records of loans to insiders;

(iv) Requiring reports and disclosures by the institution and by executive officers, directors, and principal shareholders;

(v) Disseminating policy information;

(vi) Revising policies to reflect subsequent changes in the law;

(vii) Educating employees about the legal requirements and management's related policies and procedures;

(viii) Prior approval of the board of directors or its committees, as appropriate; and

(ix) Reporting insider loans to regulatory agencies on the institution's Call Report or TFR.

d. *Insider Transactions.* Obtain a list of loans or other extensions of credit to insiders (including their related interests) during the fiscal year and management's written representations regarding—

(i) The completeness of the list, and

(ii) Whether the terms of insider transactions are comparable to those that would have been available to unaffiliated third parties.

Procedure: Select a sample of the insider transactions from the list. For each transaction in the sample selected:

(1) Ascertain that each executive officer and principal shareholder (or related interest) has reported annually to the board of directors, on or before January 31 of the following year, any indebtedness to correspondent banks, and that such report states:

(a) The maximum amount of indebtedness during the previous calendar year;

(b) The amount of indebtedness outstanding 10 days prior to report filing; and

(c) A description of the loan terms and conditions, including the rate or range of interest rates, original amount and date, maturity date, payment terms, security, and any unusual terms or conditions.

(2)(a) Trace and agree amounts outstanding by insiders to the schedule aggregating indebtedness of all insiders on the institution's year-end Call Report or TFR;

(b) Obtain from management documentation that indicates whether the specific extensions of credit, at the option of the institution, will become due and payable at any time that the insider is indebted to any other insured institution in an aggregate amount greater than the amount specified for a category of credit in 12 CFR 215.5(c);

(c) Obtain from management a copy of the institution's written notification to the insider to ascertain whether the insider has been informed of the reporting requirements relative to insider transactions and has acknowledged such requirements;

(d) If the credit exceeds the lesser of the calculation obtained in paragraph 2b. or $500,000, read the minutes of the meetings of the board of directors and determine whether the minutes indicate that the credit was approved in advance by the board and the insider abstained from participating directly or indirectly in voting on the transactions; and

(e) Obtain management's calculated legal lending limit for the credit and ascertain whether the amount of the credit exceeds such limit.

(3) For executive officers, directors, and principal shareholders of the institution included in the sample, obtain a written history of the insider's overdrafts for the year and obtain management's representation whether that history is complete. In addition,

(a) Inquire whether cash items for the individual are being held by the institution to prevent an overdraft, and

(b) Trace and agree subsequent payment by the insider of the insider's overdrafts to records of the account at the institution.

(4) For overdrafts of executive officers and directors included in the sample that are being paid by the institution for the executive officer and director on an account at the institution:

(a) Trace and agree to a written, pre-authorized, interest-bearing extension of credit plan that specifies a method of repayment; or,

(b) Trace and agree to a written, pre-authorized transfer of funds from another account of the insider at the institution; or,

(c) For aggregate amounts of $1,000 or less, obtain a written representation from management that:

(i) It believes the overdraft was inadvertent,

(ii) The account was overdrawn in each case for less than 5 business days, and

(iii) The institution charged the executive officer and director the same fee that it would charge any other customer in similar circumstances.

(5) For extensions of credit to an executive officer selected, ascertain that each credit was:

(a) Preceded by a submission of a financial statement;

(b) Promptly reported to the board of directors; and

(c) Made subject to the condition, as specified in the note or other evidence of indebtedness, that the extension of credit will become, at the option of the institution, due and payable at any time that the executive officer is indebted to other insured institutions in an aggregate amount greater than the executive officer would be able to borrow from the institution.

(6) Based on the types of transactions in the sample selected, select a sample of similar transactions with persons who are not insiders of the institution or its affiliates as of the same dates or within two weeks of the

insider transaction. Compare the terms of the transactions with the persons not affiliated with the institution to those with insiders, and note in the findings any material differences in the terms favorable to insiders compared to the terms of the transactions with persons not affiliated with the institution or its affiliates.

> ***Commentary:*** *The independent accountant's selection of "similar" transactions and comparison of terms should only relate to objectively measurable characteristics of the loan (for example, the stated interest rate, or the type of loan).*

(7) Aggregate the indebtedness to executive officers, directors, and principal shareholders of the institution and to their related interests from the list obtained as of the end of the fiscal year and one other day selected during the year. Compare this total with 100 percent of the institution's unimpaired capital and surplus at the one day selected during the year and the end of its fiscal year. (The unimpaired capital and surplus calculated from the most recent Call Report or TFR may be used, unless there is reason to believe that a significant change has taken place between the dates.) Report any excess as an exception in the findings.

> ***Commentary:*** *The independent accountant should state his or her objective criterion for "significant change" if applicable.*

e. *Executive Officers' Reports.* Obtain a list of all written reports made by executive officers of the institution concerning debt with other insured institutions, and management's representation concerning the completeness of such list.

Procedure: Select a sample of written reports. For reports selected, note any reported aggregate extensions of credit in excess of the amounts management represents the executive officer would have been able to borrow from the reporting institution and whether the report was made within 10 days of the date the indebtedness reached such a level.

> ***Commentary:*** *The preceding procedures relate to the insider's debt at other institutions. The procedures that follow relate to the insider's debt at the covered institution.*

Obtain management's calculation of:

(i) The aggregate amount of loans and other extensions or lines of credit to the executive officer and

(ii) 2.5 percent of the institution's capital and unimpaired surplus.

Recalculate management's computations for mathematical accuracy and trace amounts used in management's computations to the institution's Call Report or TFR. Ascertain whether the aggregate amount of the credits for the executive officer exceeds the greater of 2.5 percent of the institution's capital and unimpaired surplus or $25,000, but in no event more than $100,000, unless such credits are used to finance the education of the executive officer's children or the officer's principal residence. If the credit extended is a real estate loan, obtain documentation for the credit and note whether such documentation contains representations that:

(i) The purpose of the credit is for the purchase, construction, maintenance, or improvement of the executive officer's principal residence;

(ii) The credit is secured by a first lien on the residence; and

(iii) The executive officer owns or expects to own the residence after the extension of credit.

B. Dividend Restrictions

1. *Designated Laws.* The following federal laws and regulations (Designated Dividend Laws) should be read:

(a) The laws codified at 12 U.S.C. 56, 60, 1467(a)(f), 1831o; and

(b) The regulations set forth at 12 CFR 5.61, 5.62, 6.6, 7.6120, 208.19, and 563.134.

***Commentary:** The independent accountant should also read any state laws identified by management in its assertion.*

2. *Information and Procedures.* Obtain from management of the institution, and read, the following information for the institution's most recent fiscal year through the date of the attestation report, and perform the procedures indicated with respect to such information:

a. *Management's Assessment.* Obtain management's assessment of the institution's compliance with the Designated Dividend Laws and any applicable state laws and regulations cited in management's assessment. Also obtain management's written representation whether dividends declared comply with the legal limitations and any restrictions on dividend payments under any supervisory agreements, orders, or resolution of any regulatory agency (including a description of the nature of any such agreement, order, or resolution).

b. *Policies and Procedures.* Obtain in the institution's written policies and procedures concerning its compliance with the Designated Dividend Laws. If the institution has no written policies and procedures, obtain from the institution a narrative that describes the institution's methods for complying with Designated Dividend Laws, includes provisions similar to those below.

Procedure: Ascertain whether the policies and procedures include, or incorporate by reference, provisions which are consistent with the Designated Dividend Laws. For banks and savings institutions, these would include capital limitation tests, including section 38 of the FDI Act, earnings limitation tests, transfers from surplus to undivided profits, and restrictions imposed under any supervisory agreements, resolutions, or orders of any federal or state bank regulatory agency. For savings associations, include prior notification to the OTS.

c. *Board Minutes.* Obtain minutes of the meetings of the board of directors for the most recent fiscal year to ascertain whether dividends (either paid or unpaid) have been declared.

Procedure: Trace and agree total dividend amounts to the general ledger records and the institution's appropriate Call Reports or TFRs filed with regulators.

d. *Calculation.* Obtain management's computation of the amount at which declaration of a dividend would cause the institution to be undercapitalized.

Procedure: Recalculate management's computation (for mathematical accuracy) and compare management's calculations to the amount of any dividend declared to determine whether it exceeded the amount.

e. *National and State Member Banks.* Obtain management's computation concerning its compliance with 12 U.S.C. 56, "Capital Limitation Test," 12 U.S.C. 60, "The Earnings Limitation Test," and transfers from surplus to undivided profits after payment of the dividends referenced in subsection 2c. above.

Procedure: Recalculate management's computations (for mathematical accuracy) and compare management's calculations to the standards defined in the test set forth in subsection 2d. above to ascertain whether the dividends declared fall under the permissible level under this standard. If dividends are not permissible under such standard, ascertain if the dividends were declared under approval of the appropriate federal banking agency or any other exception. If not, report the exception in the findings.

f. *Savings Associations.* Obtain management's documentation of the OTS determination of whether the institution is a Tier 1, Tier 2, or Tier 3 savings institution and management's computation of its capital ratio after declaration of dividends under the Tier determined by the OTS. For dividends declared, obtain a copy of the savings institution's notification to the OTS to ascertain whether notification was made at least 30 days before payment of any dividends.

Procedure: Recalculate management's computation (for mathematical accuracy) and trace amounts used by management in its calculation to the institution's TFRs.

Section II—Procedures for Independent Public Accountant

If the internal auditor has performed the procedures set forth in section I, the following procedures may be performed by the independent public accountant if neither the FDIC nor the appropriate federal banking agency has objected in writing. If the procedures in section I have been performed by an internal auditor employed by a holding company, such procedures should be applied to each subsidiary institution (a Covered Subsidiary) subject to this part. The report of procedures performed and list of exceptions found by the internal auditor, identifying the institution with respect to which any exception was found, should be submitted to the audit committee of the board of directors.

A. Review of Designated Laws

The Designated Insider Laws and Designated Dividend Laws applicable to the institution should be read.

B. Information and Procedures

Obtain from management of the institution, and read, the following information for the institution's most recent fiscal year through the date of the attestation report, and perform the procedures indicated with respect to such information:

1. *Designated Laws.* Read section I of this schedule. Obtain management's assessment contained in its management report on the institution's or holding company's compliance with the Designated Laws.

2. *Internal Auditor's Workpapers.* If an internal auditor performed the procedures in Section I, obtain the internal auditor's workpapers documenting the performance of those procedures on the institution, including all Covered Subsidiaries, and the chief internal auditor's written representation that:

(a) The internal auditor or audit staff, if applicable, performed the procedures listed in section I on the institution and each Covered Subsidiary;

(b) The internal auditor tested a sufficient number of transactions governed by the Designated Laws so that the testing was representative of the institution's or Covered Subsidiary's volume of transactions;

(c) The workpapers accurately reflect the work performed by the internal auditor and, if applicable, the internal audit staff;

(d) The workpapers obtained are complete; and

(e) The internal auditor's report, which describes the procedures performed for the preceding fiscal year as well as the internal auditor's findings and exceptions noted, has been presented to the institution's audit committee.

Procedure: Compare the workpapers to the procedures that are required to be performed under section I, and report as an exception any procedures not documented and any procedures for which the sample size is not sufficient.

> ***Commentary:*** *The independent accountant should compare sample sizes to those in the table at the beginning of section I of this appendix. A subjective determination about the sufficiency of sample sizes is beyond the scope of an agreed-upon procedures attestation engagement.*

Compare the exceptions and errors listed by the internal auditor in its report to the audit committee to those found in the workpapers, and report as an exception any exception or error found in the internal auditor's workpapers and not listed in the internal auditor's list of exceptions.

> ***Commentary:*** *The objective of this procedure is to ensure that any findings identified as such by internal auditors in their workpapers are also included in their report to the institution's audit committee.*

C. Testing by Independent Public Accountant

The accountant should perform the procedures listed in section I on a representative sample of the transactions of the institution and Covered Subsidiaries to which each of the Designated Laws applies. The sample tested at each institution, or Covered Subsidiary, should be at least 20 percent of the size of the sample tested by the internal auditor at such institution, although samples selected should be from the population at large.

> ***Commentary:*** *The independent accountant should consult any future guidance issued on reporting of procedures performed on internal auditors' workpapers. The independent accountant's sample should be selected from the population at large, not from the internal auditor's sample.*

If the testing is being performed on a holding company with more than one Covered Subsidiary, the sample tested for each Designated Law should include transactions from each such subsidiary at least every other fiscal year. If the holding company has more than eight Covered Subsidiaries, the sample of transactions tested for each Designated Law should include transactions from each such subsidiary at least every third fiscal year.

D. Reports Concerning Holding Companies

Only one report of any exceptions noted from application of the procedures in section II performed by the independent public accountant on all Covered Subsidiaries of a holding company should be filed as required by guideline 3, but the report should identify, for each exception or error noted, the identity of the Covered Subsidiary to which it relates.

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Appendix C

Guidance for Independent Auditors When Required to Provide Access to or Photocopies of Workpapers to Regulators[1]

[This Notice to Practitioners appeared in the July/August 1993 issue of the *CPA Letter*]

The AICPA AdHoc Task Force on Auditor Workpapers has developed guidance for independent auditors to consider when they are obligated by law, regulation, or audit contract to provide access to or photocopies of audit workpapers to a regulator. This guidance has not been approved, disapproved, or otherwise acted upon by a senior technical committee of the AICPA.

The guidelines that follow were developed to assist auditors in fulfilling these obligations while also maintaining control over the workpapers. (The guidance does not apply to situations involving a request from the IRS, or firm practice-monitoring programs to comply with AICPA or state professional requirements, such as peer or quality reviews, or in response to a subpoena.)

Statement on Auditing Standards (SAS) No. 41, *Working Papers* (AU section 339), provides auditors guidance on the functions, nature, content, ownership and custody of working papers.[2] SAS No. 41 (AU section 339) observes that working papers are the property of the auditor. However, in some situations, auditors may be obligated to provide access to or photocopies of their workpapers to a regulator.

Providing Access to Workpapers

When the auditor is required by law, regulation, or audit contract to provide the regulator access to workpapers, the auditor should:

- Ensure that the client and the audit team are aware that the workpapers may be reviewed by regulators, and have the client acknowledge in the engagement letter that the workpapers are the property of the auditor but the regulator may be provided with access to workpapers, upon request in accordance with the law, regulation, or audit contract.

Sample language which may be included in the engagement letter follows:

> The working papers for this engagement are the property of [*name of firm*] and constitute confidential information. However, as required by [*law, regulation, or the terms of the audit contract*], we are required to make certain workpapers available to [*name of regulator*] upon request for their regulatory oversight purposes. Access to the requested workpapers will be provided to [*name of regulator*] under the supervision of [*name of firm*] audit personnel and at a location designated by our firm.

- Ensure that a request for access to workpapers by the regulator is in writing. The auditor should communicate specific details (such as date, time, and location) to the client of how access to the workpapers will be provided, and request the client acknowledge to the auditor in writing that the auditor is **required** to provide such access to the regulator. In the event the client does not comply with this request, the auditor may wish to consult his or her own legal counsel.

- Maintain control over the workpapers at all times. Unless expressly provided for by law, regulation, or audit contract, only workpapers related to specific requests should be made available.

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[1] The term "regulator" includes federal, state, and local government officials with legal oversight authority over the entity being audited.

[2] SAS No. 41 (AU section 339) states that "working papers are records kept by the auditor of the procedures applied, the tests performed, the information obtained, and the pertinent conclusions reached in the engagement. Examples of working papers are audit programs, analyses, memoranda, letters of confirmation and representation, abstracts of company documents, and schedules or commentaries prepared or obtained by the auditor."

Providing Photocopies of Workpapers

In addition to the above guidelines, when required by law, regulation, or contract to provide a regulator photocopies of workpapers, the auditor should—

- Provide copies of only those specific portions of workpapers that were requested, preferably only requests made during the course of an on-site review.
- Consider asking the client to review requested workpaper copies before they are submitted to the regulator.
- Ensure that control over copies of the workpapers is maintained by having all workpaper copies clearly labeled as confidential and by noting that secondary distribution of the workpapers is not permitted without the written approval of the auditor. Copies should be transmitted to the regulator with a cover letter requesting confidential treatment of information contained in the workpapers.

  Sample language for the cover letter follows:

  These workpapers are submitted as CONFIDENTIAL. Exemption from disclosure to nongovernmental parties of these documents and any copies of them is claimed under the Freedom of Information Act and all other applicable provisions of law and regulation. Before any disclosure is permitted of these documents, including any part or copies of them, please provide notice to [*insert name, address and telephone number of auditor or his or her representatives*].

Members should contact the AICPA's Auditing Standards Division at (212) 596-6036 with questions.

[The next page is 8461.]

AAM Section 8200

High-Technology Industry Developments—1993

Industry and Economic Developments

.01 The high-technology industry is one of the fastest growing segments of the U.S. economy. Although there is no precise definition of the high-technology industry, the term is commonly used to refer to companies that concentrate on using scientific theories and applications to develop new products and new applications that significantly enhance productivity. Companies often referred to as high technology include those in fields such as computers and related equipment and software, electronics, telecommunications, robotics, biotechnology, medical technology, instrumentation, and other applied sciences.

.02 The high-technology industry consists of enterprises that range in size and age from small companies in the development stage to some of the largest corporations in the world. Many of the younger enterprises are experiencing rapid rates of growth and present auditors with risks that are unique in the growth environment. Some of the older companies are facing the challenges of an uncertain economy and the unprecedented pace of technological change and are finding it necessary to restructure in order to continue to survive and compete. Those companies also present auditors with additional risks that require close attention in setting audit scope.

.03 In an effort to cope with changes and challenges in both the business and technological environments, many high-technology enterprises are forming new business alliances that are intended to make research and development more efficient and productive, and enhance the production and delivery of products and services to customers. Such alliances may take the form of business combinations, joint ventures, or other relationships with accounting and financial reporting ramifications that require thorough understanding and careful evaluation by auditors.

Audit Issues

Control Environment

.04 High-technology companies are often characterized by rapid growth. Many such entities are development stage enterprises or have a number of traits that are similar to those often found in such enterprises. Accordingly, the internal control structures of those high-technology companies often include unique characteristics that may affect an auditor's assessment of control risk. Characteristics that may indicate increased control risk include the following:

- *Entrepreneurial Focus of Management.* Owners and managers of high-technology companies frequently are entrepreneurs who may be more interested in the research and development functions than in accounting systems and related control procedures. As a result, control, accounting, and financial reporting functions may receive less support and attention than might be warranted.
- *Lack of Segregation of Duties.* Many high-technology companies are relatively small and they are frequently closely held. In many such entities, the entire accounting function is centered in one or a few employees. In addition, the owners or managers often have the authority to override prescribed control procedures.
- *Lack of Financial and Management Expertise.* Although the owners and managers of most high-technology companies are quite capable in manufacturing, marketing, research, and sales, a number may not be as well versed in matters of accounting, finance, and administration.

- *Informal Accounting Systems.* The limited resources of some high-technology companies may engender informal accounting systems with inadequate control procedures.

If the internal control structure of a high-technology company includes characteristics such as the preceding, control risk may be relatively high and auditors should adjust the scope of their audits accordingly. In such circumstances, auditors should understand how the owner-manager carries out the oversight of the employees entrusted with the accounting or custodial duties. Documentation of that understanding is required by AICPA Statement on Auditing Standards (SAS) No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AU section 319). If that understanding reveals that the oversight function is weak, there is increased risk that material errors and irregularities will result in misstatements in the financial statements, and a reportable condition, as defined in SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* (AU section 325), may exist.

Inventory Obsolescence

.05 Given the speed of technological advances and the highly competitive nature of many high-technology enterprises, rapid inventory obsolescence is not uncommon. The products of high-technology companies are often susceptible to frequent change intended to upgrade their performance. Product life cycles are typically short and competitive products with superior price and performance characteristics can quickly enter the marketplace. In such an environment, auditors should carefully consider whether the value at which inventories are carried is appropriate. Auditors may find that increased use of quantitative analyses can be an efficient and effective way to ascertain whether inventory amounts and trends make sense. Factors that should be considered include, but are not limited to, expected future demand for the product and anticipated technological advancements that render existing inventories obsolete. Auditors need to assess the reasonableness of sales forecasts used by management in making inventory obsolescence decisions and review inventory listings for completeness and accuracy.

Revenue Recognition

.06 The products offered by high-technology companies are, by their nature, innovative and their performance frequently is unproven. Similarly, customer expectations may be uneven. As a result, sales agreements entered into by such enterprises often include provisions for customer approval or for rather prolonged periods over which customers may cancel the agreement or return the product for various reasons. If such circumstances exist, auditors should carefully evaluate the entity's revenue recognition policies and procedures. Auditors should also obtain an understanding of the contractual relationships that are entered into with customers and should pay particularly close attention to nonstandard clauses that may alter the economic substance of otherwise standard transactions. Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 48, *Revenue Recognition When Right of Return Exists* (AU R75), provides accounting guidance that should be helpful in evaluating a high-technology entity's revenue recognition policies. Several Securities and Exchange Commission (SEC) Accounting and Auditing Enforcement Releases (AAERs) have addressed revenue recognition by high-technology enterprises. The problem areas noted include—

- Sales recorded before customer acceptance of a product. This refers to sales recorded before the risks and rewards of ownership passed to the buyer (see AAERs 40, 44, 58, 125, and 213).

- *Bill and hold or ship in place* sales. Revenue associated with such agreements qualifies for recognition only in unique and controlled circumstances (see AAERs 47, 108, 196, and 215).

- Recorded sales in which the seller has continuing involvement or which are subject to a significant future contingency (see AAERs 40, 78, 86, 145, and 303).

.07 *Computer Software Sales.* Sales or licensing of rights to computer software may present especially troublesome revenue recognition problems. The earnings process for such products typically varies because the software may be nonstandard or customized, or it may require a great deal of installation support. In addition, customer acceptance may be uncertain and sales agreements often provide lengthy trial periods, extended payment periods, and liberal termination features. AICPA Statement of Position (SOP) 91-1, *Software Revenue Recognition*, provides guidance on when revenue should be recognized and at what amounts for licensing, selling, leasing, or otherwise marketing computer software. Applying the provisions of SOP 91-1 may require considerable judgment. Auditors should be certain to fully understand the basic provisions of contracts with customers, particularly those with nonstandard terms and conditions. Auditors should also be alert to transactions with cancellation privileges, vendor duplication of software, exchange rights, and deferred payment terms, all of which are discussed in SOP 91-1.

.08 *Licensing Arrangements.* Transferring product rights by licensing or royalty arrangements is common among high-technology companies. If auditors encounter such arrangements, they should understand the products and related services being sold and consider whether all products or processes involving licensing or royalty payments are being properly identified and controlled.

.09 *Effect of Revenue Recognition on Other Audit Areas.* Auditors should consider whether uncertainties associated with revenue recognition have implications for other audit areas as well. For example, the collectibility of receivables may be affected by customers' perceptions of product performance and by support and maintenance expectations.

Research and Development

.10 High-technology companies generally depend heavily on continuing investments in research and development to either develop new products or maintain market advantages. Guidance on accounting for research and development costs is provided by FASB Statement No. 2, *Accounting for Research and Development Costs* (AC R50), which generally requires that such costs be charged to expense as incurred. Auditors of high-technology companies should be particularly skeptical about any research and development costs that are deferred. In such circumstances, they should carefully consider the adequacy of evidential matter available to support management's representation that the criteria that must be met to justify deferral are present, namely, that—

- The development of the product to which the costs relate was complete as defined in FASB Statement No. 2 (AC R50).
- The product was ready for manufacture.

Preopening or Preoperating Costs

.11 Similarly, preopening or preoperating costs are required to be expensed as incurred if an entity does not have an established track record of successfully recovering such costs through its own operations. Since many high-technology companies are in the development stage or are in the business of developing new products for which a history of recovery does not exist, it may be difficult for management to support a representation that there is sufficient experience to justify the capitalization of such costs. Auditors should consider deferral of such costs with a high degree of professional skepticism.

Research and Development Arrangements

.12 As a result of their need to fund substantial amounts of research and development costs, high-technology companies frequently enter into a variety of legal arrangements that may include debt and equity interests as well as contracts to provide research and development services for others. FASB Statement No. 68, *Research and Development Arrangements* (AC R55), specifies how enterprises should account for their obligations under arrangements for the funding of research and development by others. Auditors of high-technology companies should obtain an understanding of the facts and circumstances surrounding such arrangements that have been entered into by their clients, including the relationships among the parties involved, and consider the propriety of their clients' accounting for such arrangements in light of that understanding.

.13 *Obligation Is a Liability to Repay Other Parties.* FASB Statement No. 68 (AC R55) specifies that the enterprises must determine whether they are obligated only to perform contractual research and development for others, or whether they are otherwise obligated. To the extent the enterprises are obligated to repay the other parties regardless of the outcome of the research and development, they should record liabilities and expense research and development costs as incurred. To conclude that a liability to repay the other party does not exist, the transfer of risk related to the research and development must be substantive and genuine. FASB Statement No. 68 (AC R55) and SEC Staff Accounting Bulletin (SAB) Topic 5 O, *Research and Development Arrangements,* provide further guidance on assessing whether such risk transfers have occurred and provide examples of conditions leading to the presumption that the enterprise will repay the other party, whether contractually obligated to or not.

.14 *Loans or Advances to Other Parties.* Research and development arrangements sometimes entail the provision of loans or advances to another party. FASB Statement No. 68 (AC R55) states that "if repayment to the enterprise of any loan or advance by the enterprise to the other parties depends solely on the results of the research and development having future economic benefit, the loan or advance shall be accounted for as costs incurred by the enterprise. The costs shall be charged to research and development expense unless the loan or advance to the other parties can be identified as relating to some other activity, for example, marketing or advertising, in which case the costs shall be accounted for according to their nature." Auditors should carefully consider their client's accounting for such loans.

.15 *Issuance of Warrants or Similar Instruments.* Research and development arrangements sometimes also involve the issuance of warrants or similar instruments. FASB Statement No. 68 (AC R55) requires that the portion of the proceeds representing fair value of such instruments at the date of the arrangement be reported as paid-in capital rather than as revenue. Auditors should be alert to the issuance of warrants and similar instruments in connection with such arrangements and carefully evaluate their client's accounting for them, particularly the determination of the amount of the proceeds deemed to represent fair value and allocable to paid-in capital.

Percentage of Completion Method of Accounting

.16 Some enterprises use the percentage of completion method to account for the revenues associated with research and development contracts. Auditors of the financial statements of such enterprises should consider whether the criteria set forth in SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts,* that are indicative of an "ability to make reasonably dependable estimates" for purposes of using the percentage of completion method of accounting are present. SAS No. 57, *Auditing Accounting Estimates* (AU section 342), provides guidance to auditors on obtaining and evaluating sufficient, competent evidential matter to support significant estimates in audits of financial statements.

Loss Contingencies

.17 Because of the nature of their operations, high-technology enterprises are often faced with issues such as product liability claims and environmental claims that have the potential to result in substantial losses. Auditors of entities that face such claims should carefully evaluate whether the accounting and disclosure requirements of FASB Statement No. 5, *Accounting for Contingencies* (AC C59), have been met. Auditors of publicly held companies should also consider their clients' accounting for such claims in light of the requirements of SEC SAB No. 92, *Accounting and Disclosures Relating to Loss Contingencies,* which provides the SEC staff's interpretation of current accounting literature related to the following:

- Offsetting probable recoveries against probable contingent liabilities
- Recognition of liabilities for costs apportioned to other potential responsible parties
- Uncertainties in estimation of the extent of environmental or product liability

- The appropriate discount rate for environmental or product liabilities, if discounting is appropriate
- Accounting for exit costs
- Financial statement disclosures and disclosure of certain information outside the basic financial statements

Audit Risk Alert—1993 [AAM section 8010] contains further discussion of these matters.

Acquired Technology

.18 High-technology companies frequently purchase technology, either through the acquisition of other enterprises, direct purchases of licenses, or other arrangements. Often, when technology is acquired, either individually or as part of a business combination, it may include specific research projects that have no alternative future uses. In such instances, an allocation of the purchase price should be made to such projects and the cost allocated should be expensed immediately as required by FASB Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method* (AC B50), as well as FASB Emerging Issues Task Force (EITF) Issue No. 86-14, *Purchased Research and Development Projects in a Business Combination.* Existing products acquired may be capitalized and amortized over their useful lives. The purchase of an ongoing business may also give rise to goodwill, which should be amortized over an appropriate period. Auditors should carefully consider whether the allocations, classifications, and amortization periods associated with such transactions are appropriate. The uncertainty that results from competitive, technological, and economic factors that face the high-technology industry suggest that it is often not realistic to conclude that purchased goodwill has an indefinite life. Therefore, amortization periods of less than forty years are frequently appropriate.

Stock Options

.19 Because many high-technology companies are in the development stage and need to conserve their financial resources, they often use stock options and warrants to compensate key employees. Accounting for the issuance of such options and warrants is often a troublesome area, particularly for publicly held enterprises. Accounting for such options and warrants is addressed in Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees* (AC C47). Auditors of companies that issue options and warrants to their employees should carefully consider whether the accounting principles prescribed by APB Opinion No. 25 (AC C47) have been properly applied, in particular whether compensation expense has been recognized for any issuances of stock or warrants for less than fair value. SEC SAB Topic 4 D, *Earnings Per Share Computations in an Initial Public Offering (Cheap Stock),* provides additional guidance for publicly held companies.

Management's Discussion and Analysis—Public Companies

.20 SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AU section 550), requires that auditors read such information and consider whether the information, or the manner of its presentation, is materially inconsistent with that appearing in the financial statements. As auditors of high-technology companies that are required to file reports with the SEC read the Management's Discussion and Analysis of Operations sections of SEC filings that contain audited financial statements, they might consider whether those discussions include items such as—

- The reasonably likely effects on future operating results of known trends, such as further declines of sales of mature products. The life cycles of products of high-technology companies are frequently short because of the pace of technological change.
- Discretionary operating expenses, such as those relating to research and development, that have materially affected the most recent period presented but are not expected to have short- or long-term implications, or those matters that have not affected the most recent period presented but are expected to materially affect future periods.

* * * *

.21 Practitioners should also be aware of the economic, regulatory, and professional developments in *Audit Risk Alert—1993* [AAM section 8010] and *Compilation and Review Alert—1993* [AAM section 8015].

[The next page is 8481.]

AAM Section 8210

Real Estate Industry Developments—1993

Industry and Economic Developments

.01 Virtually all sectors of the U.S. real estate industry have experienced rather drastic and fundamental shifts over the past several years and signs of stabilization are just beginning to emerge. As the economy in general slowed down, activity in the real estate industry took a significant downturn and asset values plunged in many areas of the country after years of record surges. Actual market conditions vary by geographic region and by asset type, but some general trends are clearly discernible.

.02 Commercial properties were particularly hard hit, with an over supply of most kinds of space in almost every major market. Economic recession, changing demographics, and the trend toward corporate downsizing were primary contributors to the problems in this sector. As many businesses pursued cost reductions and reduced the numbers of employees on their payrolls, the need for office space was reduced. Many also delayed planned expansions.

.03 Decreases in equity resulting from overall declines in real estate values have led to the abandonment of properties by some owners and to an increasing number of foreclosures by financial institutions. The increased ownership by financial institutions and other lenders tends to exacerbate the downward pressure on values as the unwilling owners try to dispose of the properties at fire-sale prices.

.04 As a result, capital is virtually unavailable to the industry except for projects with proven economic viability. Banks and savings institutions have become reluctant to lend as a result of both past experience and the current regulatory environment, which subjects real estate loans to a high degree of scrutiny.

.05 The markets for apartments and for single-family homes, on the other hand, seem to be faring better. Spurred by the lowest mortgage interest rates in several decades, buyers are coming back into the market and finding properties more affordable. As a result, recovery in that sector seems to be taking hold.

.06 As a result of the overbuilding in both the commercial and residential sectors, vacancy rates are high and selling prices of many properties held for sale are depressed. In such circumstances, conditions such as the following may indicate a need to question the values at which certain real estate investments are carried:

- Cash flows from operating activities are insufficient to cover debt service.
- Current occupancy rates indicate that future cash flows to be received from the investment are lower than the amounts needed to fully recover the investment's carrying amount.
- Major tenants are experiencing financial difficulties.
- A large number of leases will expire in the near term.
- Lessors are having to make significant concessions in order to rent property.
- Properties held for sale remain unsold at subsequent balance-sheet dates.
- Other investors have decided to cease providing support or to reduce their financial commitment to a project or venture.
- Auditors' reports on financial statements of investee properties or significant debtors are modified for reasons that relate to real estate investments or mortgage loans.

As in prior down cycles in the real estate industry, there is renewed interest in the formation of real estate investment trusts (REITs). For owners and developers, REITs provide an alternative method of raising capital in a tight credit market. For investors, REITs offer a securitized investment that is an attractive alternative during a period of low interest rates. Currently, cash dividend yields of REITs are averaging about 6.5 percent compared with money market interest rates of 3 percent or less. During 1993, over $5 billion in REIT offerings were sold, triple the 1992 pace. The market value of REITs is currently about $25 billion, compared with $6 billion three years ago.

Regulatory Developments

.07 AICPA Statement on Auditing Standards (SAS) No. 22, *Planning and Supervision* (AU section 311), requires that in planning their audits, auditors consider matters affecting the industry in which the entity operates including, among other things, government regulations. Auditors consider such regulations in light of their potential impact on the financial statements being audited. SAS No. 54, *Illegal Acts by Clients* (AU section 317), distinguishes between the following two types of laws and regulations:

1. Those that have a direct and material effect on the determination of financial statement amounts

2. Those that relate more to an entity's operating aspects than to its financial and accounting aspects and, therefore, have only an indirect effect on the financial statements

While auditors should design their audits to provide reasonable assurance of detecting material misstatements of the financial statements resulting from illegal acts that have a direct and material effect on the determination of financial statement amounts, an audit performed in accordance with generally accepted auditing standards (GAAS) does not include procedures specifically designed to detect illegal acts that would have only an indirect effect on the financial statements. Nonetheless, auditors should be aware of the possibility that such illegal acts may have occurred.

.08 Real estate entities and the transactions in which they engage have become the focus of an increasing level of government regulation. Laws and regulations that affect the real estate industry are discussed in the paragraphs below.

Securities and Exchange Commission Regulations

.09 Sellers of investments in real estate, such as interests in limited partnerships, may become subject to the same Securities and Exchange Commission (SEC) registration and reporting requirements that affect other issuers of securities. Sellers of both public and private investments in real estate should prepare and file all required disclosure documents (prospectuses or offering documents) to prevent future claims by buyers that disclosures were inadequate or misleading. If the required disclosures have not been made, auditors should be alert to the existence of possible claims by buyers that may lead to the recision of sales transactions and refunds of purchase prices.

U.S. Department of Housing and Urban Development Regulations

.10 Through the Federal Housing Administration, the U.S. Department of Housing and Urban Development (HUD) regulates the development and operation of all projects for which it insures mortgages or provides rent subsidies. Entities that receive financial assistance from HUD are required to submit audited financial statements to HUD annually. The audits of those financial statements are required to be performed in accordance with GAAS, *Government Auditing Standards,* issued by the Comptroller General of the United States and commonly referred to as the Yellow Book, and the *Consolidated Audit Guide for HUD Programs,* issued by the HUD Office of the Inspector General (OIG).

.11 In July 1993, the HUD OIG issued a revised *Consolidated Audit Guide for Audits of HUD Programs,* which is effective for audits of financial statements for fiscal years ending September 30, 1993, and thereafter. The revised Guide provides program-specific audit requirements for entities that—

- Participate in HUD Section 8 programs.
- Participate in insured and coinsured multifamily projects.
- Receive HUD-held mortgages, direct loans, capital advances, and other subsidies.
- Have insured development certifications.
- Issue Government National Mortgage Association mortgage-backed securities.
- Are HUD-approved Title II nonsupervised mortgagees and loan correspondents.
- Are HUD-approved Title I nonsupervised lenders and loan correspondents.

Significant changes in the revised Guide include the incorporation of final rules (dated December 9, 1992) for mortgage approval reform and direct-endorsement expansion and for implementing Office of Management and Budget Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions.* The revised Guide also deletes the "common" compliance requirements contained in the prior Guide and provides revised suggested audit procedures for testing compliance with laws and regulations. Copies of the revised Guide (stock number 023-000-00805-0) can be obtained by writing to the Government Printing Office, Superintendent of Documents, Mail Stop SSOP, Washington, D.C. 20402-9328. The document can be ordered by phone—(202)783-3238—or fax—(202)512-2250—and charged on Visa or MasterCard.

Interstate Land Sales Full Disclosure Act

.12 Developers are required to make full disclosure in connection with the sale or lease of certain undeveloped subdivided land. The Interstate Land Sales Full Disclosure Act makes it unlawful for a developer to sell or lease, by use of the mail or any other means of interstate commerce, any land offered as part of a common promotional plan unless the land is registered with the Office of Interstate Land Sales Registration. The Act requires that a printed property report be furnished to all prospective purchasers or lessees. Similarly, the Federal Trade Commission has the authority to act on unfair or deceptive trade practices with respect to real estate sales, particularly as they relate to the marketing and selling activities of real estate companies.

Regulation Z of the Consumer Credit Protection Act

.13 Since most real estate purchases are made on credit, truth-in-lending laws can have a significant effect on the operations of real estate financing transactions. Regulation Z of the Consumer Credit Protection Act prescribes requirements for both creditors and borrowers for full disclosure of credit costs and is applicable to all real estate transactions, regardless of amount, in which individual borrowers are involved in nonbusiness transactions.

Tax Matters

.14 The Omnibus Budget Reconciliation Act (OBRA) of 1993 provides relief for real estate professionals by allowing them, for taxable years beginning in 1994, to offset net losses from rental real estate activities (that were previously treated as passive income losses) in which they materially participate against income from all sources. Material participation has the same meaning as under prior law. The most common method of achieving material participation in an activity is to work more than 500 hours in the activity in the taxable year. Other ways to achieve material participation in a rental real estate activity are (1) to perform substantially all of the participation in an activity, even if less than 100 hours, or (2) to have more than 100 hours of participation in the activity and more hours than anyone else. Limited partners, however, can only meet the material participation test for real estate through the 500-hour test.

.15 Each hour of participation in a real property trade or business can count for all of the tests for relief under the new law. Real property trades or businesses that meet the requirements of these tests are defined as any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental operation, management, leasing, or brokerage trade or business.

Audit Issues

Overall Risk Factors

.16 Although conditions vary from entity to entity, the following are among the general factors inherent in the real estate industry that influence audit risk:

Magnitude and Complexity of Transactions. There is usually a large number of highly complex transactions.

Lengthy Development Period. Construction normally involves significant lead time. Delays may result in increased costs and create concerns about the net realizable values of assets.

Financing and Liquidity Concerns. Real estate operations are often highly leveraged, creating concerns about the ability of entities in the industry to continue to be able to obtain adequate capital and to meet their obligations as they become due.

Asset Valuation

.17 In the current uncertain economic environment, impairment of assets continues to be a major concern throughout the real estate industry and a prime source of audit risk in audits of financial statements of real estate entities. Auditors should obtain reasonable assurance that management has considered all relevant factors in determining whether impairment has occurred. The subjectivity of determining the need for asset valuation allowances or write-downs, combined with continued economic uncertainty, reinforces the need for careful planning and execution of audit procedures in this area.

.18 Lack of an asset impairment evaluation system or failure of a real estate enterprise to document adequately its criteria and methods for determining whether impairments have occurred may indicate a material weakness in the enterprise's internal control structure and will generally increase the extent of judgment that must be applied by auditors in evaluating the adequacy of management's allowances and write-downs and will increase the likelihood that differences will result. The AICPA Audit and Accounting Guide *Guide for the Use of Real Estate Appraisal Information* provides guidance to help auditors understand real estate appraisal concepts and information.

.19 *Direct Investments in Real Estate Properties.* Real estate held for investments should be reported at cost, less accumulated depreciation, and should be evaluated for impairment when facts and circumstances indicate that impairment may have occurred. In assessing the recover ability of recorded asset amounts for direct investments in real estate, auditors should be alert for conditions such as those described in the "Industry and Economic Developments" section of this alert. Auditors of publicly held companies should be particularly mindful of the comments of the SEC Observer in the Financial Accounting Standards Board's (FASB's) Emerging Issues Task Force (EITF) Issue No. 84-28, *Impairment of Long-Lived Assets*; if it is probable that estimated future cash flows will be less than the net carrying value of a property, a write-down is required. The SEC has indicated that it will also accept, but not require, measurement of impairment on a discounted basis. Recovery of previous write-downs is not permitted prior to their realization.

.20 *Real Estate Held for Sale.* If it appears probable that an investment in real estate will be sold, the accounting principles applicable to real estate held for sale should be applied. Real estate held for sale (other than foreclosed real estate held for sale, which is discussed below) should be reported at the lower of cost or estimated net realizable value, using a valuation account to record declines in net realizable value from the carrying value on an individual property basis.

.21 *Foreclosed and In-Substance Foreclosed Real Estate.* AICPA Statement of Position (SOP) 92-3, *Accounting for Foreclosed Assets,* provides guidance on measuring foreclosed assets and in-substance foreclosed assets after foreclosure. Under the SOP, there is a rebuttable presumption that foreclosed assets are held for sale. The SOP requires foreclosed assets held for sale to be carried at the lower of (1) fair value minus estimated costs to sell, or (2) cost. Foreclosed assets held for the production of income should be treated the same way they would be had they been acquired in a manner other than through foreclosure. The SOP refers to FASB Statement of Financial Accounting Standards No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings* (AC D22), for its definition of fair value. In determining the appropriateness of fair values at which assets are presented in financial statements, auditors of publicly held entities should consider the guidance in Section 401.09d of the SEC's Codification of Financial Reporting Policies, which indicates that the mere adoption of strategies such as a hold-for-the-future strategy based on expectations of future price increases, or a strategy of operating repossessed collateral on one's own behalf, cannot justify use of derived accounting valuations that portray results of operations more favorably than would use of current values in active markets.

Revenue Recognition

.22 Current economic conditions may require auditors to carefully consider their clients' compliance with or changes in revenue recognition policies. Difficult economic circumstances may prompt some clients to change operating or accounting policies that affect the timing and propriety of revenue recognition. In evaluating the revenue recognition policies of clients in the real estate industry, auditors should carefully consider whether the criteria set forth in FASB Statement No. 66, *Accounting for Sales of Real Estate* (AC R10), have been met. Auditors should carefully analyze the facts and circumstances surrounding property sales to be certain that there are no formal or informal put arrangements committing the seller, its officers, or its shareholders to repurchase the property, find other buyers, or indemnify the buyer or third-party guarantors for risk of loss. Auditors should also be alert for circumstances that indicate that a seller may have provided, directly or indirectly, the funds for a down payment or the entire purchase price in a cash sale. Such situations may create relationships that meet the definition of related parties as set forth in FASB Statement No. 57, *Related Party Disclosures* (AC R36). SAS No. 45, *Omnibus Statement on Auditing Standards—1983* (AU section 334), describes procedures that are designed to determine the existence of related parties as defined by FASB Statement No. 57 (AC R36).

Acquisition, Development, and Construction Arrangements

.23 Lenders sometimes enter into real estate arrangements in which they take on virtually the same risks and potential rewards as those of owners or joint venturers. Guidance on determining the proper accounting for such arrangements is provided in AICPA Practice Bulletin 1, Exhibit I, *ADC Arrangements.*

Management's Discussion and Analysis—Public Companies

.24 SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AU section 550), requires that auditors read such information and consider whether the information, or the manner of its presentation, is materially inconsistent with that appearing in the financial statements. As auditors of real estate entities that are required to file reports with the SEC read the Management's Discussion and Analysis of Operations sections of SEC filings that contain audited financial statements, they might consider whether such discussions include items such as the following:

- Significant debt payments that will become due
- Capital requirements of planned development activities
- Trends in occupancy and rental rates

- Declining real estate values
- Changing interest rates
- Significant assumptions underlying estimates of net realizable value that are particularly sensitive to change

Entities with significant lending activities should provide information in a form substantially similar to that described in Sections III and IV of the SEC's Industry Guide 3.

Deferred Rent

.25 The continued oversupply of rental space in certain areas of the country has resulted in a renter's market in which rent abatements and other enticements have become commonplace. FASB Statement No. 13, *Accounting for Leases* (AC L10), requires that rents be recognized on a straight-line basis over the life of the lease even if payments are not made on a straight-line basis. Because of the number and magnitude of rent abatements being offered, significant deferred rent balances are sometimes recorded. In auditing such balances, auditors should carefully consider the reasonableness of assertions by management concerning the ability of tenants to continue to occupy the rental space in accordance with the lease agreement. If tenants are unable to occupy the space for the full term of the lease, deferred rents may not be fully recovered.

Availability of Funding

.26 Real estate enterprises require substantial amounts of capital. In view of the sluggish state of the industry and as the result of large losses in the recent past, many of the traditional sources of capital for the industry have curtailed their support. Banks and savings institutions have reduced their real estate lending activity due in part to past experience and also because of the increased regulatory scrutiny to which real estate lending is subject. Severe economic conditions around the world have kept foreign investors from filling the gap.

.27 SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU section 341), describes an auditor's obligation to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time as part of every audit. SAS No. 59 (AU section 341) notes that although auditors are not required to perform procedures specifically designed to detect going-concern problems, information obtained from audit procedures planned and performed to achieve other audit objectives may identify conditions or events that cause the auditor to suspect there may be such problems.

Environmental Issues

.28 The Environmental Protection Agency is empowered by law to seek recovery from any party that ever owned or operated a contaminated site, or anyone who ever generated or transported hazardous materials to a site. In view of the liabilities that may result from owning contaminated sites, virtually all real estate transactions entered into today give consideration to potential environmental liabilities. Auditors of real estate entities that face such claims should carefully evaluate whether the accounting and disclosure requirements of FASB Statement No. 5, *Accounting for Contingencies* (AC C59), have been met. They should also be cognizant of the consensus reached by the FASB in EITF Issue No. 93-5, *Accounting for Environmental Liabilities,* that, among other things, an environmental liability should be evaluated independently from any potential recovery and that the loss arising from the recognition of an environmental liability should be reduced only when a claim for recovery is probable of realization.

.29 Auditors of publicly held companies should also consider the requirements of SEC Staff Accounting Bulletin (SAB) No. 92, *Accounting and Disclosures Relating to Loss Contingencies,* which provides the SEC staff's interpretation of current accounting literature related to the following:

- Offsetting probable recoveries against probable contingent liabilities

- Recognition of liabilities for costs apportioned to other potential responsible parties
- Uncertainties in estimation of the extent of environmental or product liability
- The appropriate discount rate for environmental or product liabilities, if discounting is appropriate
- Accounting for exit costs
- Financial statement disclosures and disclosure of certain information outside the basic financial statements

Audit Risk Alert—1993 [AAM section 8010] contains further discussion of these matters.

Accounting Developments

Impairment of a Loan

.30 In May 1993, the FASB issued FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan* (AC I08), which addresses the accounting by creditors for impairment of certain loans. The Statement is applicable to all creditors and to all loans, uncollateralized as well as collateralized, except large groups of smaller-balance homogeneous loans that are collectively valued for impairment, loans that are measured at fair value or at the lower of cost or fair value, leases, and debt securities as defined in FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (AC I80). It applies to all loans that are restructured in a troubled debt restructuring involving a modification of terms.

.31 FASB Statement No. 114 (AC I08) requires that impaired loans that are within its scope be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or as a practical expedient, at the loan's observable market price or the fair value of collateral if the loan is collateral-dependent.

.32 The Statement amends FASB Statement No. 5 (AC C59) to clarify that a creditor should evaluate the collectibility of both contractual interest and contractual principal of all receivables when assessing the need for a loss accrual. The Statement also amends FASB Statement No. 15 (AC I80) to require a creditor to measure all loans that are restructured in a troubled debt restructuring involving a modification of terms in accordance with its provisions.

.33 The Statement applies to financial statements for fiscal years beginning after December 15, 1994. Earlier application is encouraged.

.34 Some real estate companies may adopt the provisions of the Statement prior to its effective date. Auditors of the financial statements of such real estate companies should carefully consider the implications of applying the new provisions of the Statement on audit risk. Aspects of applying the new Statement that warrant particular consideration include—

- Proper identification of all loans to which the Statement should be applied.
- The reasonableness of estimates of cash flows and interest rates used in discounting.
- The appropriateness of amounts used to measure impairment if alternatives to present value amounts, such as fair values of collateral or observable market prices, are used.
- The presentation of accrued interest receivable and its relationship to valuation allowances.

Sources of guidance relevant to auditing loan loss allowances include SAS No. 57, *Auditing Accounting Estimates* (AU section 342); SAS No. 11, *Using the Work of a Specialist* (AU section 336); and the Auditing Procedure Study *Auditing the Allowance for Credit Losses of Banks.*

Roll-Up Transactions

.35 A growing number of real estate enterprises are engaging in roll-ups of real estate and other limited partnerships. Auditors of financial statements of publicly held entities engaging in such transactions should consider the guidance in SEC Financial Reporting Release 38, *Roll-Up Transactions,* which requires heightened disclosure regarding fundamental changes and potential adverse effects arising from roll-up transactions as well as any conflicts of interest in, reasons for, alternatives to, and the fairness of such transactions. The release also calls for enhanced disclosures regarding valuation methods and additional pro forma financial statements. EITF Issue No. 87-21, *Change of Accounting Basis in Master Limited Partnership Transactions,* and SEC SAB No. 40, Topic 2D, *Financial Statements of Oil and Gas Offers,* provide relevant guidance on the basis of accounting for the new entity.

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.36 Practitioners should also be aware of the economic, regulatory, and professional developments in *Audit Risk Alert—1993* [AAM section 8010] and *Compilation and Review Alert—1993* [AAM section 8015].

[The next page is 9001.]

AAM Section 9000

SUPERVISION, REVIEW AND REPORT PROCESSING

This manual is a nonauthoritative kit of practice aids and, accordingly, does not include extensive explanation or discussion of authoritative pronouncements. Users of this manual are urged to refer directly to applicable authoritative pronouncements when appropriate.

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

The material in this section has been extracted from the MAP Handbook and has been edited for this manual.

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AAM Section 9100
Supervision and Review Procedures

Introduction

.01 Supervision is an important phase of all engagements. A supervisor trains staff members, determines there is an understanding of the work to be performed and ascertains that all procedures were appropriately performed.

.02 Review procedures are necessary to determine whether the objectives of the engagement and the results of the procedures performed were consistent with the conclusions presented in the accountant's or auditor's report.

Authoritative Literature

.03 The necessity for supervision is emphasized in the *AICPA Code of Professional Conduct,* which applies to all major areas of accounting practice, Rule 201, *General Standards* (ET section 201.01) states, "A member shall adequately plan and *supervise* an engagement."

.04 The first standard of fieldwork of generally accepted auditing standards states: "The work is to be adequately planned and assistants, if any, are to be properly *supervised.*"

.05 For compilation and review engagements, SSARS No. 1, *Compilation and Review of Financial Statements,* paragraph 3 (AR section 100.03), provides the guidance necessary to enable the accountant to comply with the general standards of the profession as explained in .03 above.

.06 For audit engagements, the following Statements on Auditing Standards (SAS) provide specific guidance on supervising and reviewing audit engagements:

a. SAS No. 22, *Planning and Supervision* (AU section 311), establishes broad requirements for the review of the work of assistants.

b. SAS No. 39, *Audit Sampling* (AU section 350), states that nonsampling risk can be reduced to a negligible level through such factors as adequate planning and supervision and proper conduct of a firm's audit practice.

c. SAS No. 41, *Working Papers* (AU section 339), establishes requirements for documenting the supervision of work performed.

d. SAS No. 56, *Analytical Procedures* (AU section 329), provides guidance on the use of analytical procedures and requires their use in both the planning and review of audits.

.07 In addition, the Quality Control Standard No. 1, *System of Quality Control for a CPA Firm* (QC section 10), provides that a CPA firm shall have a system of quality control. One of the elements of a quality control system discussed in this standard is supervision. Supervision as an element of quality control is defined as policies and procedures for the conduct and supervision of work to provide that the firm's work meets its standard of quality.

Phases of Supervision and Review

.08 Supervision and review are conducted in several phases:

a. Instructing and training assistants.

b. Providing the staff with an efficient and effective approach to the performance of the engagement.

c. Keeping informed of significant problems encountered.

d. Reviewing the work performed.

e. Comparing the time spent on performing the procedures required with the budget prepared for those procedures.

f. Dealing with technical differences of opinion among firm personnel.

Review Organization

.09 A firm's practice for reviewing engagements will vary depending on the size of the firm, as well as the complexity of the engagement.

.10 Some firms can justify a separate review department. While others cannot afford this functional division of duties. However, they cannot afford to omit any of the review procedures or processes. There should always be some form of reading of the reports for both professional and accounting matters as well as typographical errors after they are typed.

Firm Policy and Procedures Regarding Supervision and Review

.11 The foundation of good supervision is adequate firm policies and procedures on conducting and supervising work performed. Some examples of such policies are:

a. Procedures for planning engagements (AAM section 3000).

b. Procedures for maintaining the quality of work performed (AAM section 11,000).

c. Procedures for reviewing engagement workpapers and reports.

.12 The procedures for reviewing engagement workpapers and reports is broken into two separate components. The detailed review of the workpapers by the audit senior and the higher-level supervisory review performed by the manager and partner on the engagement.

Review of Workpapers

.13 The purpose of the detailed review of the workpapers on an engagement is to determine:

a. All procedures in the program, albeit audit, review or compilation, were performed and documented.

b. The results and conclusions reached are appropriate for the work performed.

c. The results are properly summarized and in agreement with the report to be issued.

Supervisory Review

.14 The purpose of the supervisory review is to determine that:

a. Professional and firm standards have been complied with.

b. Accounting and auditing concerns for the client's industry were evaluated properly.

c. The overall results of the procedures performed are appropriate.

[The next page is 9201.]

AAM Section 9200

Partner's Functional Area Engagement Review Program

	Yes	No	N/A
I. .010 Independence			
A. Were the policies and procedures established by the firm appropriately followed? (Are the policies and procedures in accordance with the AICPA Statements on Quality Control Standards?)	____	____	____
B. If the firm was not independent, was the lack of independence disclosed in a report limited to a disclaimer of opinion for a public company, or if applicable, to a compilation report for a nonpublic company?	____	____	____
C. Was any evidence noted during the audit which may indicate impaired independence (including a lack of objectivity or threatened litigation), and if so, was the matter identified and appropriately resolved?	____	____	____
D. Was timely and appropriate assurance of independence of other firms engaged to perform segments of the engagement obtained?	____	____	____
E. For non-SEC clients, were the fees for the prior year's services paid prior to issuance of the report for the current engagement?	____	____	____
F. For SEC clients, if the fees for the prior year's services were not paid prior to the commencement of the current engagement, were the SEC rules for unpaid professional fees adhered to as well as the AICPA rules?	____	____	____
II. .020 Assigning Personnel to Engagements			
A. Were the policies and procedures established by the firm appropriately followed? (Are the policies and procedures in accordance with the AICPA Statements on Quality Control Standards?)	____	____	____
B. Were scheduling and staffing requirements approved on a timely basis by the appropriate person?	____	____	____
C. Is the level of experience of the personnel assigned or supervision given appropriate for the auditor's assessment of the level of risk for the engagement?	____	____	____
D. Were the personnel assigned to the engagement sufficiently trained for the technical expertise required?	____	____	____
III. .030 Consultation			
A. Were the policies and procedures established by the firm appropriately followed? (Are the policies and procedures in accordance with the AICPA Statements on Quality Control Standards?)	____	____	____
B. If according to firm policy, consultation was required, was appropriate consultation made and documented?	____	____	____
C. If a difference of opinion on a practice problem existed between engagement personnel and a specialist or other consultant, was the difference resolved in accordance with firm policy and appropriately documented?	____	____	____
IV. .040 Supervision			
A. Were the policies and procedures established by the firm appropriately followed? (Are the policies and procedures in accordance with the AICPA Statements on Quality Control Standards?)	____	____	____
B. Was audit planning adequately documented in the working papers, including any changes in the original plan?	____	____	____
C. Were appropriate personnel assigned to the engagement involved in the planning process?	____	____	____

	Yes	No	N/A
D. Was background information related to specialized industry developed or, if information was obtained from prior engagements, was it updated for changed circumstances (e.g., proposed work program, manpower requirements, etc.)?	____	____	____
E. Was the overall audit plan approved by the appropriate person and conveyed to the engagement staff?	____	____	____
F. Was adequate supervision provided considering the background and experience of personnel assigned to the engagement?	____	____	____
G. If specialized skills were used, (e.g., computer auditing, statistical sampling, etc.) were they evaluated by persons with training in these areas? (SAS No. 48 [AU section 311])	____	____	____
H. Were hours charged by the partner and manager both adequate and appropriately timed to provide for planning and supervision as the job progressed?	____	____	____
I. Were the form and content of audit working papers adequate and prepared in accordance with firm policy?	____	____	____
J. If required by firm policy, were all forms, checklists, and questionnaires for the following areas adequately completed and modified, where appropriate, for the engagement:			
1. Planning checklists?	____	____	____
2. Consideration of the internal control structure?	____	____	____
3. Audit work programs?	____	____	____
4. Financial statement disclosures?	____	____	____
5. Time budgets and progress reports?	____	____	____
6. Working papers and financial statement reviews?	____	____	____
K. If standardized forms, checklists, etc., were not used for any of the above areas, is there other adequate documentation?	____	____	____
L. Was the guidance in the relevant literature, including AICPA audit and accounting guides considered during the engagement?	____	____	____
M. Was an appropriate review made of the report and financial statements to determine that they conform to professional standards and firm policy?	____	____	____
V. .050 Professional Development			
A. Were the policies and procedures established by the firm appropriately followed? (Are the policies and procedures in accordance with the AICPA Statements on Quality Control Standards?)	____	____	____
B. Does it appear that there was adequate on-the-job training (consider such things as pre- and post-audit conferences, tour of client's facilities, monitoring staff progress, etc.)?	____	____	____
C. Were the staff on the engagement properly evaluated based on the work performed?	____	____	____
VI. .060 Acceptance and Continuance of Clients			
A. Were the policies and procedures established by the firm appropriately followed? (Are the policies and procedures in accordance with the AICPA Statements on Quality Control Standards?)	____	____	____
B. Did the firm comply with its Quality Review guidelines for acceptance and continuance of clients?	____	____	____

This audit engagement has been completed in accordance with professional standards and firm policy.

Partner______________________________________ Date______________

[The next page is 9221.]

AAM Section 9210
Partner's Engagement Review Program

The Partner's Engagement Review Program should be used for all engagements. The supplemental programs for Not-for-Profit Organizations, Local Governmental Units, and Banks should be completed in conjunction with the Partner's Engagement Review Program.

	Yes	No	N/A
I. General Procedures			
A. .010 General			
1. Has the "Partner's Functional Area Review Program" (see AAM section 9200) been completed?	____	____	____
2. In planning the audit engagement, were the following matters properly considered?			
a. Matters affecting the environment in which the entity operates, such as accounting practices, economic conditions, government regulations, contractual obligations and technological changes. (SAS No. 22 [AU section 311])	____	____	____
b. Matters affecting the entity's operations, such as legal organization and types of services. (SAS No. 22 [AU section 311])	____	____	____
c. Preliminary judgment about materiality levels for audit purposes. (SAS No. 47 [AU section 312])	____	____	____
d. Consideration of the internal control structure. (SAS No. 55 [AU section 319])	____	____	____
e. Conditions that may require extension or modification of audit tests, such as the possibility of material errors or irregularities and management's ability to override controls. (SAS No. 53 [AU section 316])	____	____	____
f. Other audit risks.	____	____	____
3. If the firm succeeded a predecessor accountant, did the firm:			
a. Communicate with the predecessor accountant to ascertain whether there were disagreements between the predecessor accountant and the entity's management on accounting or auditing matters and consider the implications of such matters in accepting the client?	____	____	____
b. Make other inquiries of the predecessor accountant on significant matters?	____	____	____
c. Satisfy itself on the fair presentation of opening balances, such as reviewing the predecessor accountant's working papers?	____	____	____
4. Did the firm obtain an understanding of the internal control structure consisting of the control environment, the accounting system, and control procedures? (SAS No. 55 [AU section 319])	____	____	____
a. Was an understanding of the internal control structure documented? (SAS No. 55 [AU section 319])	____	____	____
b. Did the firm assess control risk? (SAS No. 55 [AU section 319])	____	____	____
c. If the firm assessed control risk at below maximum level:			
(1) Were internal control structure policies and procedures identified relevant to specific assertions that are likely to prevent or detect material misstatements? (SAS No. 55 [AU section 319])	____	____	____
(2) Were adequate tests of controls to evaluate the effectiveness of such policies and procedures performed to support the assessed level of control risk? (SAS No. 55 [AU section 319])	____	____	____

	Yes	No	N/A
d. If the client used computer processing in significant accounting applications, did the assessment of risk in the internal control structure include an evaluation of the extent, as well as the complexity, of that processing, including those, if any, of an outside service center? (SAS Nos. 48, 55, and 70 [AU sections 311, 319, and 324])	____	____	____
e. If the firm relied on the internal control structure at a service organization, was a service auditor's report obtained and appropriately considered? (SAS No. 70 [AU section 324])	____	____	____
5. If consideration was given to the work of internal auditors in determining the scope of the audit, was it done in accordance with SAS No. 65 (AU section 322)?	____	____	____
6. Was audit planning appropriately documented?	____	____	____
7. Was a written audit program prepared? (SAS No. 22 [AU section 311])	____	____	____
a. Was it responsive to the needs of the engagement identified during the planning process and was it developed in light of the internal control structure? (SAS No. 55 [AU section 319])	____	____	____
b. Was consideration given to applicable assertions in developing audit objectives and in designing substantive tests? (SAS No. 31, paragraphs 9 through 13 [AU section 326.09—.13])	____	____	____
c. Were tests considered regarding related party transactions? (SAS No. 45 [AU section 334])	____	____	____
d. If conditions changed during the course of the audit, was the audit program modified as appropriate in the circumstances?	____	____	____
e. Was guidance in the applicable AICPA Audit and Accounting Guide considered?	____	____	____
8. If statistical or nonstatistical sampling was used in test of controls (SAS No. 39, paragraphs 31 through 42 [AU section 350.31—.42]):			
a. Was appropriate consideration given, in planning the sampling application, to the relationship of the sample to the objective of the test, maximum rate of deviation, allowable risk of assessing control risk too low and likely rate of deviations?	____	____	____
b. Was the sample selected in such a way that it could be expected to be representative of the population?	____	____	____
c. Were the results of the sample evaluated as to their effect on the nature, timing, and extent of planned substantive procedures?	____	____	____
d. Was appropriate consideration given, in evaluating the sample, to items for which the planned test or appropriate alternative procedure could not be performed, for example, because the documentation was missing?	____	____	____
e. Was documentation of the foregoing considerations in accordance with firm policy?	____	____	____
9. If statistical or nonstatistical sampling was used for substantive tests of details (SAS No. 39, paragraphs 15 through 30 [AU section 350.15—.30]):			
a. Was appropriate consideration given, in planning the sampling application, to the relationship of the sample to the audit objective, preliminary judgments about materiality levels, auditor's allowable risk of incorrect acceptance, and characteristics of the population?	____	____	____
b. Was the sample selected in such a way that it could be expected to be representative of the population?	____	____	____
c. Were the misstatement results of the sample projected to the items from which the sample was selected?	____	____	____
d. Was appropriate consideration given, in evaluating the sample, to items for which the planned substantive tests or appropriate alternate procedures could not be performed?	____	____	____

	Yes	No	N/A
e. Was appropriate consideration given, in the aggregate, to projected misstatement results from all audit sampling applications and to all known misstatements from nonsampling applications in evaluating material misstatements in the financial statements?			
f. Was documentation of the foregoing considerations in accordance with firm policy?			
10. Were the guidelines of SAS No. 56 (AU section 329), followed in the performance of analytical procedures for:			
a. Audit planning?			
b. Use as a substantive test?			
c. Overall review of the audit?			
11. Did the firm obtain timely and appropriate responses from the auditee's attorney concerning litigation, claims, and assessments? (SAS No. 12 [AU section 337])			
12. Have all required engagement forms and documents been completed, signed, and dated?			
13. Have all questions, exceptions, or notes, if any, posed during the audit been followed up and resolved, including consideration of the views obtained from responsible officials of the organization, program, activity, or function audited concerning the auditor's findings, conclusions, and recommendations?			
14. Did the firm obtain a timely appropriate letter of representation from management? (SAS No. 19 [AU section 333])			
15. Does it appear that appropriate consideration was given to all past adjustments and to the risk that the current period's financial statements are materially misstated? (SAS No. 47 [AU section 312])			
16. Were errors, irregularities, or illegal acts, if any, followed up in accordance with SAS Nos. 53 and 54 (AU sections 316 and 317)?			
17. Have reportable conditions, if any, in the internal control structure been communicated to the audit committee or to individuals with a level of authority and responsibility equivalent to an audit committee in organizations that do not have one? (SAS No. 60 [AU section 325])			
18. If required by firm policy, was an appropriate engagement letter issued?			
19. Were communications of internal control structure related matters issued in accordance with SAS No. 60 (AU section 325)?			
20. Was consideration given to the work of internal auditors in determining the scope of the audit in accordance with SAS No. 65 (AU section 322)?			
21. If specialized skills were used (e.g., computer auditing, statistical sampling, etc.), were they properly evaluated by persons with training in these areas? (SAS No. 39 [AU section 350])			
22. Did the planning and execution of the engagement include an assessment of the risk of errors and irregularities and management's ability to override control procedures? (SAS No. 53 [AU section 316])			
23. Did the audit strategy and expected conduct and scope of the audit reflect the following assessments:			
a. The risk of material misstatement in the financial statements?			
b. The risk of management misrepresentation?			
24. Was the audit designed to provide reasonable assurance of detecting material misstatements?			
25. If it has been determined that an audit adjustment is, or may be, an irregularity but it has also been determined that the effect on the financial statements would not be material, has the following been performed:			
a. Referral of the matter to an appropriate level of management that is at least one level above those involved?			

	Yes	No	N/A
b. Obtain satisfaction that, in view of the organizational position of the likely perpetrator, the irregularity has no implications for other aspects of the audit or that those implications have been adequately considered?	____	____	____
26. If it has been determined that an audit adjustment is, or may be, an irregularity and the auditor has either determined that the effect could be material or has been unable to evaluate the potential materiality, has the following been performed?			
a. Consideration of the implications for other aspects of the audit.	____	____	____
b. Discussions of the matter and the approach to further investigate the irregularity with an appropriate level of management that is at least one level above those involved.	____	____	____
c. Obtaining sufficient competent evidential matter to determine whether, in fact, material irregularities exist and, if so, their effect.	____	____	____
d. If appropriate, suggestions that the client consult with legal counsel on matters concerning questions of law.	____	____	____
27. When it has been concluded that an illegal act has or is likely to have occurred, have the following been considered?			
a. The effect on the financial statements.	____	____	____
b. The implications for other aspects of the audit.	____	____	____
c. Communication with the audit committee.	____	____	____
d. The effect on the auditor's report.	____	____	____
28. If the engagement included the use of the work (domestic or international) of another office, correspondent, or affiliate:			
a. Do the instructions to the other office or firm appear adequate?	____	____	____
b. Does it appear that control exercised over the work of others through supervision and review was adequate?	____	____	____
c. Was there appropriate follow-up of open matters?	____	____	____
d. Were appropriate inquiries made as to its professional reputation?	____	____	____
29. Does the firm's disclosure checklist document that the audit report is properly prepared and that the financial statements are fairly stated?	____	____	____
30. Were matters related to the conduct of the audit communicated to those who have responsibility for oversight of the financial reporting process? (SAS No. 61 [AU section 380])?	____	____	____
31. Was the applicable disclosure checklist completed?	____	____	____

II. Working Paper Areas

A. .020 Cash

	Yes	No	N/A
1. Was due consideration given to cash transactions shortly before and shortly after the balance sheet date to determine that transactions were recorded in the proper period?	____	____	____
2. Were bank accounts confirmed at the audit date and were reconciling items existing at the balance sheet date cleared by reference to subsequent statements obtained directly from the bank?	____	____	____
3. Do the working papers indicate that the following were considered?			
a. Restrictions on cash balances.	____	____	____
b. Confirmation of bank credit arrangements such as compensating balances.	____	____	____
c. Review of confirmation responses for indication of related party transactions.	____	____	____
4. Based on the assessed level of control risk, do the substantive tests of cash appear adequate?	____	____	____

B. .030 **Receivables**	Yes	No	N/A
1. Was a summary prepared (or obtained) properly classifying receivables (i.e., notes and accounts receivable; trade; officers, directors, and employees; parent and subsidiary companies; other related party transactions; etc.)?			
2. If accounts receivable are not confirmed, has the reason been documented? One of the following is acceptable:			
a. Accounts receivable are immaterial to the financial statements.			
b. Use of confirmations would be ineffective.			
c. Combined assessed level of inherent and control risk is low (as addressed in the internal control section), and the assessed level, in conjunction with other evidence (analytical procedures or other substantive tests) reduced audit risk to an acceptably low level for applicable financial statement assertions.			
3. Were accounts receivable confirmations circularized and appropriate follow-up steps taken?			
4. If confirmation work was performed prior to year-end, is there evidence that an adequate review was made of transactions from the confirmation date to the balance sheet date?			
5. If a significant number and amount of accounts receivable confirmations were not circularized, is there evidence that other auditing procedures were performed?			
6. Were significant notes receivable confirmed as of the audit date?			
7. Were the results of confirmation procedures summarized in the working papers?			
8. Was collateral (if any) for receivables examined with respect to existence, ownership, and value?			
9. Were adequate tests made of discounts and allowances?			
10. Was the reasonableness of allowances for doubtful accounts covered in the working papers and collectibility of receivables adequately considered?			
11. Is there evidence in the working papers that inquiry was made and consideration given to whether receivables are pledged or factored?			
12. Was receivables work coordinated with test of sales including inventory cut-off tests?			
13. Are notes receivable accounted for to reasonably represent the present value of the consideration exchanged and at an appropriate interest rate? (APB Opinion No. 21 [AC I69])			
14. Based on the assessed level of control risk, do the substantive tests of receivables appear adequate?			
C. .040 **Inventories**			
1. Was an inventory summary prepared (or obtained) showing basis (e.g., "costs," "market," "LIFO," "FIFO," etc.) with respect to the various classifications of inventory (e.g., finished goods, work-in-process, raw materials, etc.)?			
2. Where the physical inventory is taken at a date other than the balance sheet date (or where rotating procedures are used), do the working papers indicate that consideration was given to inventory transactions between the inventory date(s) and the balance sheet date?			
3. Do the working papers contain evidence that counts were correctly made and recorded (i.e., was control maintained over inventory tags or count sheets) and were test count quantities reconciled with counts reflected in final inventory?			
4. Do the working papers indicate that adequate tests were made of:			
a. The clerical accuracy of inventory footings?			
b. Costing methods and substantiation of costs used in pricing all elements (raw materials, work-in-process, finished goods) of the inventory?			
5. Do the working papers indicate that a lower of cost or market test was performed (including obsolescence)?			

	Yes	No	N/A
6. If perpetual inventory records are maintained, do the working papers indicate that differences disclosed by the client's physical inventory (or cycle counts) are properly reflected in the accounts?	____	____	____
7. Was an examination of purchase and sales commitments made, including consideration as to any possible adverse effects?	____	____	____
8. Were appropriate inventory cut-off tests performed?	____	____	____
9. Where applicable, were gross profit percentage tests employed to check overall valuation of inventories?	____	____	____
10. Where the physical inventory in the hands of others was not observed, were inventory confirmations received (i.e., inventory in public warehouses, on consignment, etc.)?	____	____	____
11. Do the working papers indicate that steps were performed to determine if any inventory is pledged?	____	____	____
12. Based on the assessed level of control risk, do the substantive tests of inventory appear adequate?	____	____	____
D. .050 Investments			
1. Was a summary schedule prepared (or obtained) and details examined with respect to description, purchase price and data, changes during period, income market value, etc., of investments?	____	____	____
2. Were all securities (including stock certificates of subsidiary companies) examined or confirmed?	____	____	____
3. Was investigation made of carrying value and possible cost impairment of long-term investments?	____	____	____
4. Do the working papers indicate that consideration was given to indications that investments were pledged?	____	____	____
5. Were financial statements and other information reviewed to support the amounts presented for investments accounted for using the equity method?	____	____	____
6. Do the working papers indicate that adequate evidential matter has been accumulated for long-term investments?	____	____	____
7. Based on the assessed level of control risks, do the substantive tests of investments appear adequate?	____	____	____
E. .060 Prepaid Expenses, Intangible Assets, Deferred Charges, Etc.			
1. Were adequate tests made and/or confirmations received for all material:			
a. Prepaid expenses?	____	____	____
b. Intangible assets?	____	____	____
c. Deferred charges?	____	____	____
d. Other?	____	____	____
2. For prepayments, intangibles, and deferred charges, is there adequate support for the deferral and amortization (or lack thereof)?	____	____	____
3. If insurance policies were pledged as collateral or subjected to premium financing, were the related loans properly accounted for?	____	____	____
4. Based on the assessed level of control risk, do the substantive tests of prepaid expenses, intangible assets, deferred charges, etc., appear adequate?	____	____	____
F. .070 Property, Plant, and Equipment			
1. Was a summary schedule prepared (or obtained) to show beginning balances, changes during the period, and ending balances for:			
a. Property, plant, and equipment?	____	____	____
b. Accumulated depreciation?	____	____	____
2. Do tests appear adequate with respect to:			
a. Additions:			
(1) Examination of supporting documents?	____	____	____

	Yes	No	N/A
(2) Physical inspection?			
b. Retirement, etc. (including examination of miscellaneous income, scrap sales, etc.)?			
c. The adequacy of current and accumulated provisions for depreciation and depletion?			
d. Compliance with control procedures?			
e. Status of idle facilities?			
3. Do the working papers indicate the presence of liens on property?			
4. Were differences between book and tax depreciation reconciled?			
5. Based on the assessed level of control risk, do the substantive tests of property, plant, and equipment appear adequate?			
G. .080 Current Liabilities			
1. Were accounts payable adequately tested for propriety?			
2. Was an adequate test made of subsequent transactions (i.e., cash disbursements, voucher register entries, vouchers, unpaid invoices, etc.) to determine if any material unrecorded liabilities existed?			
3. Was the payable work correlated with the purchase cutoff examination?			
4. Was consideration given to costs and expenses that might require accrual (e.g., compensated absences), and to whether accrued expenses were reasonably stated?			
5. Based on the assessed level of control risk, do the substantive tests of liabilities appear adequate?			
H. .090 Long-Term Debt			
1. Were confirmations received for significant debt obligations, together with verification of interest rates, repayment period, etc.?			
2. Is there evidence that covenants to long-term debt obligations are being complied with?			
3. Have leases been examined to determine that capital leases have been properly accounted for?			
4. Do the working papers include evidence as to compliance with any loan restrictions?			
5. Based on the assessed level of control risk, do the substantive tests of long-term debt appear adequate?			
I. .100 Deferred Credits			
1. Do the working papers indicate that:			
a. The basis of deferring income is reasonable and on a consistent basis from year to year?			
b. Deferrals have been established on a reasonable basis?			
2. Based on the assessed level of control risk, do the substantive tests of deferred credits appear adequate?			
J. .110 Income Taxes			
1. Were current and deferred tax accrual accounts and related provisions analyzed and reviewed as to adequacy?			
2. Do the workpapers document the determination of the adequacy of the income tax accruals and provisions in accordance with federal, state, local regulations and GAAP and any possible adjustments required for:			
a. Tax positions taken by the client that might be challenged by the taxing authorities?			
b. Possible assessments, penalties or interest indicated by tax return examinations completed during the year or in progress, including similar adjustments applicable to years not yet examined?			

	Yes	No	N/A
3. Based on the review of the financial statements and working papers and, if necessary, discussions with engagement personnel, does it appear tax matters were adequately considered?	___	___	___
4. Based on the assessed level of control risk, do the substantive tests of income taxes appear adequate?	___	___	___
K. .120 Commitments and Contingencies			
1. Do the working papers include indication of the following?			
a. Inspection of minutes of meetings of the stockholders, board of directors, and executive and other committees of the board.	___	___	___
b. Inspection of contracts, loan agreements, leases, and correspondence from taxing and other governmental agencies, and similar documents.	___	___	___
c. Accumulation and analysis of confirmation responses from banks and lawyers.	___	___	___
d. Inquiry and discussion with management (including management's written representations concerning liabilities, and litigation, claims, and assessments).	___	___	___
e. Inspection of other documents for possible guarantees by the client.	___	___	___
2. Is there indication that procedures were performed to uncover the need for recording or disclosure of events subsequent to the date of the financial statements?			
3. Based on the assessed level of control risk, do the substantive tests of commitments and contingencies appear adequate?	___	___	___
L. .130 Capital Accounts			
1. Were changes in capitalization checked to authorizations?	___	___	___
2. Do the working papers indicate that adequate inquiries were made as to:			
a. Stock options?	___	___	___
b. Warrants?	___	___	___
c. Rights?	___	___	___
d. Redemptions?	___	___	___
e. Conversion Privileges?	___	___	___
3. Based on the assessed level of control risk, do the substantive tests of capital accounts appear adequate?	___	___	___
M. .140 Income and Expenses			
1. Were tests made of payrolls, including account distribution?	___	___	___
2. With regard to pension and profit sharing plans (including impact of ERISA), do tests of expenses and liabilities appear adequate?	___	___	___
3. Were revenue and expenses for the period compared with those of the preceding period and reviewed for reasonableness; were significant fluctuations explained?	___	___	___
4. Was adequate consideration given to review of the client's revenue recognition policy and unusual sales transactions?	___	___	___
5. Has adequate consideration been given to loss contingencies in accordance with FASB Statement No. 5 (AC C59)?	___	___	___
6. Based upon the assessed level of control risk, do the substantive tests (review, analysis, and casting) of income and expense appear adequate?	___	___	___
N. .150 Other			
1. Were procedures applied to supplementary information in accordance with SAS No. 52 (AU section 558), as applicable?	___	___	___

	Yes	No	N/A
2. If the work of a specialist was used, was the effect of the specialist's work on the auditor's report considered in accordance with SAS No. 11, paragraphs 9 through 12 (AU section 336.09—.12)?	____	____	____
3. Were specific procedures applied for determining the existence of related parties and examining identified related party transactions? (SAS No. 45 [AU section 334])	____	____	____
4. Was the guidance in SAS No. 47 (AU section 312) regarding audit risk and materiality considered during the planning and performance of the engagement?	____	____	____

This audit engagement has been completed in accordance with professional standards and firm policy.

Partner____ Date______________

[The next page is 9271.]

AAM Section 9220

Partner's Engagement Review Program Supplement for Not-for-Profit Organizations

***To be completed in conjunction with Partner's Engagement Review Program** [AAM section 9210]*

	Yes	No	N/A
I. General Audit Procedures			
A. .010 General			
[No additional General Audit Procedures are required as part of this supplement.]			
II. Working Paper Areas			
A. .020 Cash			
1. Do the working papers indicate that the following were considered?			
a. Confirmation of liabilities and contingent liabilities to banks.	___	___	___
b. Authorization for interfund cash transactions.	___	___	___
c. Determination that all cash accounts have been identified and appropriately recorded.	___	___	___
B. .030 Receivables			
1. Were procedures performed to provide evidence that pledged receivables are properly recorded in the appropriate funds?	___	___	___
C. .040 Investments			
1. Were income and realized and unrealized gains and losses from investments examined for proper allocation to the individual funds?	___	___	___
2. Do the working papers indicate that risk of loss on repurchase agreements was properly considered?	___	___	___
3. Do the working papers indicate that repurchase security transactions were reviewed for consistency with the disclosures of the terms or circumstances of the transactions?	___	___	___
D. .050 Collections of Works of Art and Similar Items			
1. If the collection is considered inexhaustible (i.e., exhibits owned by museums, art galleries, botanical gardens, etc.) and has been capitalized, do the working papers indicate that the auditor tested the reasonableness of the collection's carrying value?	___	___	___
2. If the collection is considered exhaustible and has been capitalized, do the working papers indicate that the auditor tested the reasonableness of the collection's carrying value and related amortization?	___	___	___
3. Are the tests adequate with respect to acquisitions and deaccessions?	___	___	___
4. If the collection is capitalized:			
a. Were physical inventories observed at all locations where relatively large amounts are located?	___	___	___
b. Do the working papers contain evidence that counts were correctly made and recorded (i.e., was control over inventory tags or count sheets maintained) and were test count quantities reconciled with the quantities reflected in the final inventory?	___	___	___
5. If the collection is considered inexhaustible and has been capitalized, do the working papers indicate that the auditor:			
a. Evaluated the internal controls over the collection?	___	___	___

	Yes	No	N/A
b. Observed a physical inventory at all locations where large amounts are located?			
6. Based on the assessed level of control risk, do the substantive tests of collections of works of art and similar items appear adequate?			
E. .060 Property, Plant, and Equipment			
1. Was a review made to determine that capital expenditures are classified in the proper fund accounts?			
F. .070 Liabilities			
1. Were liabilities properly classified as current or long-term and in the proper fund?			
2. Were procedures performed to determine whether tax deferred annuity plans are appropriately calculated to conform with GAAP and IRS regulations?			
3. Was consideration given to any liabilities (including the effect of any temporary differences) resulting from the federal excise tax on investment income and any federal and state taxes on unrelated business income?			
4. Do the tests of interfund borrowings appear adequate with respect to:			
a. Legal restrictions, if any, on such borrowings?			
b. Authorization?			
c. Classification?			
d. Collectibility of amounts due from other funds?			
e. Appropriateness of interest accruals and payments?			
G. .080 Deferred Revenue			
1. Do the working papers indicate that consideration was given to whether the basis of deferring revenue is reasonable and consistent with the donors' or grantors' restrictions?			
2. Was consideration given to matching requirements, if any?			
3. Do the working papers indicate that consideration was given to the appropriateness of the amounts of restricted gifts, grants, bequests, donations, or other income recognized as current revenue or support?			
4. Based on the assessed level of control risk, do the substantive tests of deferred revenue appear adequate?			
H. .090 Commitments and Contingencies			
1. Did the auditor consider evidence of the entity's activities (such as lobbying) which might cause the entity to lose its tax exempt status or be subject to penalties or taxes?			
2. If the entity is a private foundation, as defined by IRC section 509, did the auditor determine whether the entity complied with IRS regulations concerning required distribution of income and prohibited activities?			
I. .100 Fund Balance			
1. Where appropriate, were authorizations of changes in reserves and designated balances examined?			
2. Do the working papers indicate that there were adequate inquiries, where appropriate, as to proper classification, description and disclosure of components of the fund balance?			
3. Do the working papers indicate that fund transfers were properly approved and recorded?			
4. If an endowment fund is maintained, do the working papers indicate that fund income is distributed to unrestricted and restricted funds in accordance with donors' stipulations?			
5. Based on the assessed level of control risk do the substantive tests of fund balances appear adequate?			
J. .110 Revenues, Expenses, Support, and Capital Additions			

	Yes	No	N/A
1. Were revenues and expenses for the period compared with those of the preceding period and reviewed for reasonableness and were significant fluctuations explained?	____	____	____
2. Was adequate consideration given to:			
a. The entity's revenue recognition policy?	____	____	____
b. Income recognition on transactions where the earnings process is not complete?	____	____	____
3. Do the working papers indicate that consideration was given to the valuation and classification of revenue derived from service fees, such as subscription and membership income, and sales of publications and other items?	____	____	____
4. If the entity is reimbursed by a third party for costs incurred in connection with providing services to others:			
a. Were pertinent sections of significant third party contracts reviewed to determine the basis for reimbursement?	____	____	____
b. Were cost reimbursement reports and the underlying support reviewed?	____	____	____
c. Were appropriate allocations made of indirect costs among the entity's programs?	____	____	____
5. Do the working papers indicate that the auditor considered actual receipt of, rights to, and any restrictions placed on amounts received during the current period from:			
a. Cash contributions?	____	____	____
b. Donated services?	____	____	____
c. Gifts of securities, materials, facilities, and other nonmonetary items?	____	____	____
d. Future interests and interest free loans?	____	____	____
6. If expenses are classified by function, did the auditor adequately test the classifications and allocations?	____	____	____
7. If grants are awarded to other organizations, did the auditor review:			
a. The classification of the grants?	____	____	____
b. The effects of the grantees' compliance or noncompliance with performance requirements?	____	____	____
8. Were tests of payrolls performed, including account distribution?	____	____	____
9. With regard to pension plans, do the tests made of the expense and liabilities appear adequate?	____	____	____
10. Based upon the assessed level of control risk, did the substantive tests (review, analysis, and testing) of revenues and expenditures/expense appear adequate?	____	____	____

K. .120 Other

	Yes	No	N/A
1. If the entity is affiliated or otherwise financially related to other entities, did the auditor consider the need for combined financial statements or disclosure of the relationship?	____	____	____

III. Audits of Governmental Grantees

Note: These questions are derived from the U.S. General Accounting Office's (GAO) *Government Auditing Standards* ("Yellow Book") and the Office of Management and Budget, Circular A-110 *(Uniform Administrative Requirements for Grants and Other Agreements with Institutions of Higher Education, Hospitals, and Other Nonprofit Organizations).*

A. .130 General

	Yes	No	N/A
1. If the audit was required to be conducted in accordance with the *Government Auditing Standards,* do the auditor's report(s) include references to *Government Auditing Standards,* and appropriately cover:			
a. The financial statements, including, where presented, the combining and individual fund financial statements?	____	____	____

	Yes	No	N/A
b. Tests of controls based solely on the evaluation of the effectiveness of the controls made as part of the audit of the financial statements?	____	____	____
c. Compliance with finance-related legal and contractual provisions, including a summary of questioned costs and/or instances of noncompliance?	____	____	____
d. Instances or indications of illegal acts that could result in criminal prosecution of the top officials of the entity arranging the audit?	____	____	____
2. If required, did the auditor's report on internal control identify:			
a. The scope of the auditor's work in obtaining an understanding of the internal control structure and in assessing control risk?	____	____	____
b. The entity's significant internal control structure including those controls established to ensure compliance with laws and regulations that have a material impact on the financial statements?	____	____	____
c. The reportable conditions, including the identification of material weaknesses identified as a result of the auditor's work in understanding and assessing control risk?	____	____	____
3. If required, did the auditor's report on compliance include:			
a. A statement of positive assurance with respect to those items tested for compliance with applicable laws and regulations?	____	____	____
b. Negative assurance on those items not tested?	____	____	____
c. A summary of material instances of noncompliance?	____	____	____
4. If required by contractual obligations, were findings presented in accordance with the guidance in the *Government Auditing Standards* regarding reporting on economy and efficiency audits and program results audits?	____	____	____
5. Was interfund activity properly reviewed and were differences between total interfund receivables and total interfund payables investigated and resolved?	____	____	____
6. If applicable, were adequate tests of controls with applicable laws and regulations made?	____	____	____
7. Were all reportable conditions in the internal control structure and all identified instances of noncompliance with applicable laws and regulations:			
a. Adequately evaluated and documented?	____	____	____
b. Appropriately reported in accordance with applicable standards? (SAS No. 60 [AU section 325]; GAO's *Government Auditing Standards,* pp. 5-6 and 5-7; OMB A-110, Attachment F)	____	____	____
8. Do the working papers indicate that consideration was given to prior audits of government financial assistance programs that disclosed questionable or disallowed costs, or instance of noncompliance?	____	____	____

This audit engagement has been completed in accordance with professional standards and firm policy.

Partner____ Date______________

[The next page is 9351.]

AAM Section 9230

Partner's Engagement Review Program Supplement for Local Governmental Units

To be completed in conjunction with Partner's Engagement Review Program [AAM section 9210]

	Yes	No	N/A
I. General Audit Procedures			
A. .010 General			
1. In planning the audit engagement, were the following matters properly considered?			
a. Matters affecting the government, such as specialized accounting practices, economic conditions, federal and state laws and regulations, and technological changes. (SAS No. 22 [AU section 311])	____	____	____
b. Definition of the reporting entity indicating the related organizations, functions, and activities which are either included or excluded from the financial statements in accordance with GASB Cod. Sec. 2100.	____	____	____
c. Factors affecting the continued functioning of the government, such as legal limitations on revenue, expenditures, or debt service.	____	____	____
2. If statistical or nonstatistical sampling was used for tests of applicable laws and regulations, if appropriate (SAS No. 39, paragraphs 15 through 30 [AU section 350.15—.30]):			
a. Was consideration given, in planning the sampling application, to the relationship of the sample to the audit objective, preliminary judgments about materiality levels, auditor's allowable level of risk of incorrect acceptance, and characteristics of the population?	____	____	____
b. Was the sample selected in such a way that it could be expected to be representative of the population?	____	____	____
c. Were the misstatement results of the sample projected to the items from which the sample was selected?	____	____	____
d. Was consideration given, in evaluating the sample, to items for which the planned substantive tests or appropriate alternate procedures could not be performed?	____	____	____
e. Was consideration given, in the aggregate, to projected misstatement results from all audit sampling applications and to all known misstatements from nonsampling applications in evaluating material misstatements in the financial statements?	____	____	____
f. Was the documentation of the foregoing considerations in accordance with firm policy?	____	____	____
3. If applicable, were adequate tests of controls with applicable laws and regulations made?	____	____	____
4. Were all reportable conditions in the internal control structure, all identified instances of noncompliance with applicable laws and regulations, and all illegal acts:			
a. Adequately evaluated and documented?	____	____	____
b. Appropriately reported in accordance with applicable standards? (SAS No. 60 [AU section 325]; GAO's *Government Auditing Standards,* pp. 5-6 and 5-7; OMB Circular A-128, paragraph 13)	____	____	____

II. Working Paper Areas

	Yes	No	N/A
A. .020 Cash			
1. Do the working papers indicate that the following were considered:			
a. Confirmation of liabilities and contingent liabilities to banks?	____	____	____
b. Approval of interfund cash transactions?	____	____	____
c. Verification of collateral required of depository institutions for public funds?	____	____	____
d. Compliance with the laws and regulations governing the deposit of public funds?	____	____	____
e. Determination that all cash accounts have been identified and appropriately recorded?	____	____	____
f. Review of repurchase security transactions for consistency with the disclosures of the terms or circumstances of the transactions?	____	____	____
B. .030 Receivables			
1. Was a summary classifying receivables prepared or obtained (i.e., notes and accounts receivable, tax revenues, interfund transactions, and other related party receivables, etc.)?	____	____	____
2. Were procedures performed to provide evidence that taxes receivable and the related revenues have been recorded in the correct period in accordance with GASB Cod. Sec. P70?	____	____	____
3. Was the reasonableness of allowances for doubtful accounts covered in the working papers and collectibility for receivables, including interfund receivables, adequately considered?	____	____	____
4. Was receivable work coordinated with tests of revenues, including cutoff tests?	____	____	____
C. .040 Investments			
1. Was a review made to determine whether the investments are of the types authorized by law or comply with the applicable statutes and investment policy?	____	____	____
2. Were income, gains and losses from investments examined for proper allocation to the individual funds?	____	____	____
3. For repurchase and reverse repurchase agreements, were appropriate audit procedures performed (e.g., confirmation, inspection of collateral, etc.)?	____	____	____
D. .050 Property, Plant, and Equipment			
1. Was a review made to determine that capital expenditures are classified in the proper fund accounts and made in accordance with budgetary requirements?	____	____	____
E. .060 Liabilities			
1. Were liabilities properly classified as current or included in the general long-term debt account group?	____	____	____
2. Was consideration given to expenditures and expenses that might require accrual (e.g., pensions, compensated absences—see GASB Cod. Sec. 1600), and to whether accrued expenses were reasonably stated?	____	____	____
3. Were procedures performed to determine whether deferred compensation plans are appropriately disclosed or reported? (GASB Statement No. 2)	____	____	____
4. Do the working papers include evidence regarding compliance with loan restrictions?	____	____	____
5. Was an examination made to determine that:			
a. New debt issues are properly issued as required by the state constitution or state/local statute and are recorded in the correct fund and/or account group?	____	____	____
b. Debt restrictions, guarantees, and other debt commitments are properly disclosed?	____	____	____
6. Do the tests of interfund borrowings appear adequate with respect to:			
a. Legal restrictions, if any, on such borrowings?	____	____	____
b. Authorization?	____	____	____

	Yes	No	N/A
c. Classification?	____	____	____
d. Appropriateness of interest accruals and payments?	____	____	____

F. .070 Deferred Revenue

	Yes	No	N/A
1. Do the working papers reflect consideration of whether the basis of deferring revenue is reasonable and consistent with restrictions imposed by the grantor or by the special assessment?			
2. Was consideration given to matching requirements, if any?	____	____	____

G. .080 Commitments and Contingencies

	Yes	No	N/A
1. Do the working papers include indication of the following?			
a. Inspection of minutes of meetings of the governmental body and key committees thereof, provisions of the governmental unit's charter, and applicable statutes and changes therein.	____	____	____
b. Inspection of long-term contracts with non-governmental entities, such as construction contractors.	____	____	____
2. Have all material contingencies been properly considered, documented, and reported (SFAS No. 5 [AC C59]; GASB Cod. Sec. C50)?	____	____	____

H. .090 Fund Equity

	Yes	No	N/A
1. Were authorizations of changes in reserves and designated balances examined?	____	____	____
2. Do the working papers indicate that there were inquiries, where appropriate, as to proper classification, description, and disclosures of components of fund equity?	____	____	____
3. Do the working papers indicate that fund transfers were properly approved and recorded?	____	____	____
4. Based on the assessed level of control risk, do the substantive tests of fund equity appear adequate?	____	____	____

I. .100 Revenues and Expenditures/Expenses

	Yes	No	N/A
1. Were revenues and expenditures and/or expenses for the period compared with those of the preceding period and reviewed for reasonableness and were significant fluctuations explained?	____	____	____
2. Was adequate consideration given to the entity's revenue recognition policy?	____	____	____
3. Do the working papers indicate that revenues and interfund transactions have been recognized in the accounting period in which they became available and measurable under the applicable basis of accounting?	____	____	____
4. Do the working papers indicate that the auditor considered the effect of program income on federal grants and any related activities?	____	____	____
5. Has it been determined that:			
a. Expenditures are in accordance with the approved budget as to amounts and purpose?	____	____	____
b. Encumbrances are properly identified, supported, and recorded?	____	____	____
6. Were tests of payrolls performed, including account distribution?	____	____	____
7. With regard to pension plans, do tests of expenditures and liabilities appear adequate?	____	____	____
8. If the entity is reimbursed by a third party for costs incurred in connection with providing services to others:			
a. Were pertinent sections of significant third party contracts reviewed to determine the basis for reimbursement?	____	____	____
b. Were cost reimbursement reports and the underlying support reviewed?	____	____	____
c. Were appropriate allocations made of indirect costs among the entity's programs?	____	____	____
d. Was the effect of audits, either required or performed by third party grantors, considered?	____	____	____

	Yes	No	N/A
9. If grants are awarded to other organizations, did the auditor review:			
a. The classification of the grants?	____	____	____
b. The effects of the grantees' compliance or noncompliance with performance requirements?	____	____	____
10. Based upon the assessed level of control risk, did the substantive tests (review, analysis, and testing) of revenues and expenditures/expense appear adequate?	____	____	____

J. .110 Other

	Yes	No	N/A
1. Have leases been examined to determine that capital, sales, and direct financing leases have been properly accounted for? (GASB Cod. Sec. L20)	____	____	____

III. Compliance With the Requirements of the Single Audit Act of 1984

A. .120 The Single Audit Act

	Yes	No	N/A
1. If required or deemed necessary, is there any indication that the firm discussed and agreed on the scope of the engagement with the auditee?	____	____	____
2. Did the firm, by reviewing contract files and receipts and disbursements, obtain reasonable assurance that the auditee appropriately identified all federal financial assistance and included that assistance within the audit scope?	____	____	____
3. If required, does the schedule of federal financial assistance program expenditures present the following?			
a. Identification of each program as indicated in the *Catalog of Federal Domestic Assistance* (CFDA).	____	____	____
b. Other federal assistance from programs not included in the CFDA.	____	____	____
c. Total expenditures for each federal financial assistance program by grantor, department, or agency.	____	____	____
d. Total federal financial assistance.	____	____	____
e. Other information, required by federal program managers or otherwise deemed appropriate.	____	____	____
4. Was consideration given to the accounting and auditing guidance issued by the Office of Management and Budget, including Circulars A-128 (*Audits of State and Local Governments*), A-87 (*Cost Principles Applicable to Grants and Contracts*), and A-102 (*Uniform Requirements for Assistance to State and Local Governments*)?	____	____	____
5. Did the firm obtain an understanding of the internal control structure policies and procedures, as it relates to:			
a. Administering major federal financial assistance programs, comparable to that which the auditor would perform if control risk was assessed at below the maximum level? (SAS No. 55 [AU section 319])	____	____	____
b. Administering non-major programs to the same extent as in question 5a above, so that over 50% of total federal assistance program expenditures are considered?	____	____	____
c. Other non-major federal financial assistance programs? (SOP 90-9)	____	____	____
6. For those programs where the control risk is assessed at the maximum level, is the firm's understanding of the internal control structure, as well as the conclusion of the control risk, documented? (SAS No. 55 [AU section 319])	____	____	____
7. For categories of controls for which the control risk is below the maximum level:			
a. Do the working papers document the firm's understanding of the internal control structure?	____	____	____
b. Were tests of controls performed for the internal control structure?	____	____	____
c. Was the nature and extent of testing sufficient to enable the firm to determine if the control procedures were being applied as described?	____	____	____

	Yes	No	N/A
d. Did the auditor examine the recipient's control structure for ensuring subrecipients' compliance and obtaining and acting on subrecipients' audit reports?	____	____	____
e. Do the working papers adequately document the work performed and the conclusions reached? (GAO, p. 6-21; SAS No. 41, paragraph 5 [AU section 339.05])	____	____	____
8. Were all reportable conditions in the internal control structure disclosed in the auditor's reports?	____	____	____
9. In determining whether the entity has complied with applicable laws and regulations that may have a material effect on each major federal financial assistance program, did the auditor:			
a. Consult appropriate sources, such as the Compliance Supplement for Single Audits of State and Local Governments, statutes, regulations, and agreements covering individual programs, in order to identify the compliance requirements that apply to each major program and to determine which requirements to test?	____	____	____
b. Select a representative number of charges from each major program?	____	____	____
c. Perform tests to determine whether:			
(1) The amounts reported as expenditures were allowable under federal regulations and contracts?	____	____	____
(2) Only eligible persons or organizations received services or benefits?	____	____	____
(3) Matching requirements were met?	____	____	____
(4) Federal financial reports and claims for advances and reimbursements were supported by the records supporting the financial statements?	____	____	____
(5) The entity complied with each of the general requirements contained in the compliance supplement concerning:			
(a) Political activity?	____	____	____
(b) Civil rights?	____	____	____
(c) Davis-Bacon Act?	____	____	____
(d) Cash management?	____	____	____
(e) Relocation of assistance and real property acquisition?	____	____	____
(f) Federal financial reports?	____	____	____
(g) Allowable costs/cost principles?	____	____	____
(h) Drug-free workplace?	____	____	____
(i) Administration requirements?	____	____	____
d. Consider projected misstatement results from all audit sampling applications and all known misstatements from non-sampling applications?	____	____	____
e. Consider whether tests of compliance with the program's requirements appear adequate to support the report(s) on compliance?	____	____	____
10. Where transactions related to non-major federal financial assistance programs have been selected during other audit procedures, have they been appropriately tested for compliance with applicable laws and regulations in connection with the audit of financial statements and evaluations of internal control structure?	____	____	____
11. If warranted, did the firm communicate with the cognizant agency to avoid or minimize any disagreements or problems?	____	____	____
12. Did the firm submit the report(s) to the organization audited and to those requiring or arranging for the audit within the required time?	____	____	____
13. Has the firm established policies or procedures for complying with the additional requirements concerning:			
a. Retaining working papers and reports for a minimum of three years from the date of the audit report, unless the auditor is notified in writing by the cognizant agency to extend the retention period?	____	____	____

	Yes	No	N/A
b. Making the working papers available upon request to the cognizant agency or its designee or the GAO at the completion of the audit?	____	____	____

This audit engagement has been completed in accordance with professional standards and firm policy.

Partner____ Date________________

[The next page is 9401.]

AAM Section 9240

Partner's Engagement Review Program Supplement for Banks

To be completed in conjunction with Partner's Engagement Review Program [AAM section 9210]

	Yes	No	N/A
I. General Procedures			
A. .010 General			
1. Were FIRREA regulations considered in planning the audit engagement?	____	____	____
II. Working Paper Areas			
A. .020 General			
1. Do the working papers document the consideration of the results of inquiries, readings, excerpts or other evidence of an understanding of regulatory examinations, their findings and actions and the recognition of the above in planning the audit?	____	____	____
2. Did the engagement team obtain an adequate understanding of those factors that have a significant affect on the bank's business (i.e., interest rates, liquidity, off-balance sheet financing)?	____	____	____
3. If the client engaged in the following types of transactions, was there a review of the propriety of the accounting and recording for:			
a. Loan originations?	____	____	____
b. Loan commitments?	____	____	____
c. Fees?	____	____	____
d. Loan refinancing and restructuring?	____	____	____
e. Transfers between trading account and investment securities?	____	____	____
f. Wash sale transactions?	____	____	____
g. Hedging transactions, including interest rate swaps and interest rate futures?	____	____	____
h. Coupon stripping?	____	____	____
i. Adjusted price forward placement trades?	____	____	____
j. Reposition swaps?	____	____	____
k. Repos to maturity?	____	____	____
l. Dollar repos?	____	____	____
m. Commitments for the purchase or sale of securities?	____	____	____
n. Industrial development bonds?	____	____	____
o. Purchase or sale of options?	____	____	____
p. Purchase or sale of securities?	____	____	____
4. Did audit planning and the implementation of audit procedures adequately consider:			
a. Off-balance sheet transactions?	____	____	____
b. The appropriate accounting for investments?	____	____	____
c. Related party transactions?	____	____	____
d. Regulatory examination reports?	____	____	____
e. Regulatory agreements?	____	____	____
f. Apparent fraud and insider abuse?	____	____	____

Yes | No | N/A

5. Did the engagement team consider the risks to the bank of possible violations of regulations such as the following?
   a. The Bank Secrecy Act.
   b. Legal lending limit regulations and interest rates charged.
   c. Affiliated party transactions.
   d. The current minimum capital ratio requirements.
   e. FIRREA.
6. Was the following considered in connection with foreign exchange transactions?
   a. Reasonable assurance that material commitments and contingent liabilities related to international operations have been properly recorded and disclosed.
   b. Reasonable assurance that gains and losses from foreign exchange activities of the international department are properly recorded and disclosed.

B. .030 Cash

1. Were bank accounts in other financial institutions confirmed at the audit date and were reconciling items existing at the balance sheet date cleared by reference to subsequent statements obtained directly from the financial institutions?
2. Do the working papers indicate that the following were considered?
   a. Confirmation of liabilities and contingent liabilities to other banks.
   b. Proper recording of interest.
3. Do the workpapers indicate whether cash on hand represents currency and coins on hand?
4. Was it determined whether clearings, exchanges and in-transit items represent valid claims against the drawee bank?
5. Do the workpapers reflect whether cash items (checks cashed after close of business, maturing coupons and bonds, returned checks and other items held temporarily pending their liquidation) are properly classified?

C. .040 Investment and Trading Securities

1. Do the workpapers indicate physical evidence of the ownership of securities on hand or held in custody or safekeeping by others for the account of the bank?
2. Do the workpapers indicate whether interest and dividend income and security gains and losses were properly recorded?
3. Do the workpapers indicate whether investments have suffered a permanent reduction in recorded value?
4. Do the workpapers indicate whether allowances for losses have been provided where necessary?
5. Do the workpapers indicate whether securities have been properly identified as investment or trading securities and valued appropriately?
6. Do the workpapers indicate whether amounts for investment securities and the related income, gains and losses are properly presented in the financial statements, including disclosures of amounts pledged, market value and other related disclosures?
7. Were substantive tests of investment and trading securities adequate based on the assessed level of control risk?

D. .050 Federal Funds and Repurchase/Reverse Repurchase Agreements

1. Do the workpapers indicate whether federal funds and repurchase/reverse repurchase agreements represent valid claims against the borrower or obligations to the lender?
2. Do the workpapers indicate whether amounts shown on the financial statements are properly classified and described?
3. Based on the assessed level of control risk were substantive tests of federal funds and repurchase/reverse repurchase agreements and trading securities adequate?

	Yes	No	N/A
E. .060 Loans			
1. Was an evaluation of the adequacy of the allowance for loan losses and the selection of loans to be evaluated performed and documented?	____	____	____
2. Did the evaluation in 1 above include:			
a. The bank's lending policies and procedures including its control over loan file documentation and maintenance?	____	____	____
b. Consideration of the qualification of the bank loan officers?	____	____	____
c. Consideration of the effectiveness of the bank's internal audit and loan review program?	____	____	____
d. Consideration of the results of prior years' examinations and industry statistics?	____	____	____
e. Consideration of overall portfolio mix (industry and location), loan loss experience, and charge-off policy?	____	____	____
3. Was consideration given to the relative degrees of inherent risk, by type, for: unsecured, depressed areas or industries; concentration or political risk; geographic or economic risks?	____	____	____
4. Was consideration given to the participations purchased or sold?	____	____	____
5. Was consideration given to overdrafts?	____	____	____
6. Was consideration given to the accounting for and disclosures of related party transactions?	____	____	____
7. Was consideration given to the extent to which loan renewals and extensions are used to maintain loans on a current basis?	____	____	____
8. Was consideration given to appraisals obtained on originations and foreclosures, including the qualifications, independence and findings of the appraisers?	____	____	____
9. Was consideration given to the disclosure of indirect (off-balance sheet) liabilities such as loan commitments, interest rate swaps, loans sold with recourse and standby letters of credit as well as direct liabilities?	____	____	____
10. Were management's responses to discussions concerning the adequacy of the allowance appropriate?	____	____	____
11. Was consideration given to the propriety of acquisition, development, and construction loans? (February 1986 AICPA Notice to Practitioners)	____	____	____
12. Was consideration given to the use of watch lists, delinquency reports and other sources of potential problems including troubled debt restructurings and in-substance foreclosures?	____	____	____
13. Were individual loan files reviewed, including borrowers financial statements, evidence of collateral and cash flow information?	____	____	____
14. Did the final assessment of the adequacy of loan losses consider specific loans and historical trends?	____	____	____
15. Was there comprehensive documentation to 14 above?	____	____	____
16. If real estate or other assets acquired through foreclosure were significant to the client:			
a. Was the carrying value at the time of foreclosure evaluated and properly classified in the financial statements?	____	____	____
b. Was the continuing carrying value assessed?	____	____	____
c. Were loans restructured by the client reviewed for proper recording under the principles of FASB Statement No. 15 (AC D22)?	____	____	____
d. Was the accounting for in-substance foreclosures reviewed to determine that they were accounted for as troubled debt restructuring?	____	____	____
17. For loans, was the following considered?			
a. The bank's compliance with its internal control, i.e., approval, reports, documentation, disbursement, and collection.	____	____	____
b. Selection of a sample from all significant loan areas.	____	____	____

	Yes	No	N/A
c. Did the tests include executed notes, loan applications, financial statements of borrowers, chattels, other credit information and approvals.	____	____	____
d. Confirmation with bank customers.	____	____	____
e. Proper accounting recognition of unearned income, interest income, recognition of acquisition and other fees such as "points".	____	____	____
f. Tests of interest income to average loan balance and yield to interest rates in effect.	____	____	____
g. Testing of related party transactions and conflicts of interest.	____	____	____
h. Testing of the bank's credit card operations.	____	____	____
i. Testing of lease financing operations.	____	____	____
j. Testing of loan participations.	____	____	____
k. Review of underlying collateral.	____	____	____
18. Based on the assessed level of control risk, were substantive tests of loans adequate?	____	____	____
F. .070 Deposits			
1. Do the workpapers indicate whether deposits are recorded at the proper amounts, segregated as to type and represent valid claims?	____	____	____
2. Was it determined whether the related accrued interest and interest expense is stated on a reasonable and consistent basis?	____	____	____
3. Was it determined whether the amounts shown on the financial statements are properly classified and adequately described?	____	____	____
4. Based on the assessed level of control risk were substantive tests of deposits adequate?	____	____	____
G. .080 Director's Examinations			
1. Because the procedures may be limited in a director's examination, were the nature and extent of such procedures clearly set forth in the engagement letter?	____	____	____
2. Were state requirements considered in determining the scope of the audit?	____	____	____
3. If the examination consisted of performing certain agreed-upon procedures did the firm's report comply with the provisions of SAS No. 35 (AU section 622)?	____	____	____
H. .090 Trust Operations			
1. Were the audit procedures directed to uncover the existence of contingent liabilities arising from trust department operations?	____	____	____
2. Did the procedures include a determination of whether administrative activities (including execution of trust instructions), safekeeping of assets, recordkeeping, tax, and reporting of the trust department were appropriate to meet the trust's fiduciary responsibilities?	____	____	____
3. Do the workpapers indicate whether trust assets exist, are recorded as trust assets, segregated from bank assets and are accounted for properly?	____	____	____
4. If other independent auditors or internal auditors audit the trust operations, were appropriate procedures performed to justify reliance on them?	____	____	____

[The next page is 9441.]

AAM Section 9250
In-Charge Engagement Review Program

	Yes	No	N/A
A. .01 General Procedures			
1. Were all planning procedures performed:			
a. Have prior year's workpapers been reviewed to determined problem areas?			
b. Was the review and approval of the audit program by the manager and partner on the engagement documented?			
c. Was the understanding of the internal control structure documented?			
d. Were any changes to the assessment of control risk necessitated due to the test of controls?			
e. Was the audit program changed due to (d) above?			
f. Were the planning analytical procedures performed for major financial statement captions?			
2. Have any questionable acts (i.e., irregularities, illegal, etc.) been noted?			
3. If any questionable acts were noted were they followed up appropriately and documented?			
4. Were any suggestions for performing next year's engagement noted?			
5. Has the time budget been completed and reviewed to determine if changes for next year's budget should be made?			
B. .02 Workpapers			
1. Are the workpapers properly headed and indexed?			
2. Was the balance per the lead sheets and the trial balance agreed to the financial statements and the general ledger?			
3. Were all columns footed and cross-footed?			
4. Were important calculations, i.e., interest, depreciation, pension, taxes, and other calculations etc., recalculated or checked for reasonableness?			
5. Are all tickmarks explained?			
6. Were all confirmations received agreed to the appropriate workpapers?			
7. Were all confirmation exceptions resolved?			
8. Were statistics kept of the results of the confirmation procedures?			
9. Are all cross-references correct?			
10. Are all appropriate audit program steps performed, signed, and dated?			
11. Have all adjustments and reclassification entries been carried forward to the summary workpaper?			
12. Do the workpapers support the conclusion for the area and the opinion for the report?			
13. Do the results of the tests of controls performed support the assessed level of control risk for assertions re: significant account balances and transaction classes?			
14. Has the reviewer documented the review of the workpapers?			

[The next page is 9501.]

AAM Section 9500
Report Processing

Drafting the Report

.01 The only tangible evidence a client receives of the CPA's work is the written report. Since weeks or months of effort may have been spent in its preparation (for which the client pays a substantial fee), it is only prudent that every effort be made to insure the superior quality of its presentation.

.02 While most financial statements do not offer the opportunity for creativity in writing style, the effectiveness of many special reports is influenced by the quality of the writing. Clarity and propriety in an accountant's report are not achieved through use of long words, technical language or complicated reasoning, but through simple language used to present important thoughts, supported by documentation. Proper grammar and sentence structure improve readability. Effective use of forceful words with smooth transitions between sentences will help hold the reader's interest. If the subject matter is of deep concern to management and if management has respect for the auditor's opinion, it is likely that the recommendations will be followed by action, especially if the author communicates effectively. This is particularly true where the report is to be the basis for a management decision.

Uniformity

.03 Strict uniformity may stifle creative thinking, but a consistent format adds quality to the written report.

1. The client's name should appear at the top of every statement with identical spelling and punctuation. The certificate of incorporation should be inspected to determine the exact name of the corporation. Accuracy in seemingly small matters, such as whether "the" is part of the name, the word "Company" or "Incorporated" is abbreviated or spelled out, or commas are part of the name, is important to the accountant's reputation.

2. Descriptive phraseology should be uniform. If the phrase "cost of goods sold" is used in the income statement, then a schedule of these costs should show "cost of goods sold," not "cost of sales."

3. The manner in which the date or period covered is indicated should also be uniform. If the income statement is headed "for the year ended December 31, 19__," then all supporting schedules should be headed that way, rather than "for the year 19__."

4. Schedule and statement headings should conform to a pattern. For example, if "schedule of cost of goods sold" is used, then all other schedules should begin with "schedule of."

5. Statement and schedule headings should be the same in the letter, table of contents, index, and other references.

6. Each page should be well balanced, paragraphs should break in the right places, tables should be centered and not broken except when a table is longer than a page, page numbers should be in the same place on each sheet, type should be clean and alignment even, and there should be no "strikeovers" or visible erasures.

7. As part of firm policy, the following should be standardized:

Title	Captions
Indexing	Spacing
Salutation	Indentation
Page Numbering	Paragraphing
Closing and Signing	Capitalization
Dating	Underscoring
Whole Dollar Reporting	Punctuation
Headings	Dollar Signs

Double or Single Spacing

Draft of Report

.04 In some cases an exposure draft of the report, clearly identified as a draft, can be used effectively to afford the client an opportunity to comment on the report before it is in final form.

Report Production

.05 A *report guide sheet* usually accompanies all reports submitted for processing. Included in the report guide sheet is the basic information which relates to the specific client, such as:

1. Client name
2. Audit date
3. Engagement partner and manager
4. Date audit commenced
5. Date audit completed
6. Date report submitted for review
7. Date review completed
8. Date submitted for typing
9. Date submitted for checking
10. Date sent to client
11. Special comments, such as "rush," "date promised to client," and "hold for confirmation."

.06 The purpose of the report guide sheet is to enable the audit team to know the status of the report at all times, and to ascertain if there are any time lags in the processing of the report. The following procedures are used in its preparation.

Engagement information. The in-charge accountant enters the engagement information, delivery instructions, and "hold items" (items to be cleared prior to releasing report). He signs the report guide sheet as initial reviewer.

Review. The report is approved at various levels of review. If there is more than one reviewer (for example, two department reviewers for phases of a large job), the primary reviewer should sign the report guide sheet. If another partner or manager performed the entire review in the absence of the primary reviewer, then such other reviewer should sign the report guide sheet as overall reviewer.

Processing. The various processing levels are signed off. If more than one typist is involved, the head of the typing department or the primary typist may sign the report guide sheet. If more than one person is involved in (cont'd) comparing and proofing, the person primarily responsible should sign the report guide sheet. The review partner or his delegate should sign as final reader.

Final release. The person who signs for final release must ascertain that all other required signatures are on the report guide sheet before releasing the report.

Report production. The reverse side of the report guide sheet is usually completed by the in-charge accountant. A photocopy may be given to the report production department as advance notice of production requirements (for example, where numerous printed covers will be needed).

.07 The report guide sheet is bound with the operating office's file copy of the report. With the busy atmosphere prevailing at most firms, it is of vital importance that all work as it moves through the production process be under tight control independent of the work product and its guide sheet.

.08 A simple schedule can be maintained to control the flow of work from the date an audit engagement is begun to the date the report is finally mailed to the client. The schedule has key items arranged in columnar form and can be maintained by the office manager or another person in charge of staff assignments. Frequent references to the schedule should reveal any unusual delays in completing an engagement or typing a report.

.09 To account for each report from the time it is placed for typing to the time it is mailed or delivered to the client, some firms maintain a record in the typing department, in place of or as a supplement to the foregoing record. (See Report Production Control in AAM section 9500.13.)

.10 If this record indicates any time lags, the matter should be investigated; it may indicate either an abnormal backlog of work or some other problem.

.11 In preparing the report production control form, the following procedures are suggested:

- It should be manually prepared and updated daily by a control clerk.
- It should be retained in a notebook in a readily accessible location so that audit personnel can check report status without interfering with review and production operations.
- When a report and related workpapers are received by the reviewer, the client name, report description, fiscal year end, report-letter date, and due date should be entered.
- The review partner should assign a reviewer and record the date forwarded to the reviewer and the forwarding date for tax review.
- The person's name to whom the report is given for rework (if required) should be entered and the dates forwarded for tax and audit reviews of rework are recorded (if required).
- Other dates should be recorded through final release.

.12

Report Guide Sheet
(To be bound with the—colored copy of report)

Engagement Information

Client ______________________ Date Due ______________________
Assignment Number ______________________ Assignment Name ______________________
Partner ______________ Manager ______________ In-Charge Accountant ______________

____ Compiled Financial Statements Period ______________________
____ Reviewed Financial Statements Period ______________________
____ Audited Financial Statements Period ______________________
____ Review of Interim Financial Information Period ______________________
____ Special Reports—Description: Date ______________________

Delivery Instructions:
Name—attention of: ______________________ ____ Mail
Address: ______________________ ____ Delivery by:
______________________ ______________________

Hold Items

	Cleared by	Date
____ Attorney Letter		
____ Letter of Representation		

Report Review:

	Signature	Date
Prepared by		
Manager		
Review Department		
Tax Department		
Partner		

Report Processing:

	Signature	Date
Typing Department		
Comparing and Proofing		
Final Reading		

Final Release:
The report(s) described above were released by me after all hold items were cleared. All appropriate levels of review were signed off, and all processing steps completed.

______________________ ______________________
Signature Date

Report Guide Sheet (continued)

Report Description (Exactly as it will appear):

____ Financial Statements and Accountant's Report (Compilation) (Review) Report
____ Financial Statement and Independent Auditor's Report
____ Unaudited (Interim) Financial (Statements) (Information) (and Accountant's Review Report)
____ Other Title

____
____

Client ______________________________ Date ____________

Report Production:

Covers: ____ Printed ____ Typed

Report Copies:

<u>In covers</u>

Client					
File					
Other					

Uncovered	Workpaper copies (at least two)	Extra file copies
Working Paper		
Extra		

Other Production Instructions:

____
____
____
____
____
____
____
____

.13

Report Production Control

Client	Report description	Dates: FYE	Dates: Report letter	Dates: Due	Reviewer name	Dates forwarded for: Review: Audit	Review: Tax	Rework: Date	Rework: To (name)	Rework review: Audit	Rework review: Tax	Type & proof	Final read	Multilith	Hold	Final release

Signing Reports

.14 After the report has been reviewed, typed, proofread, and corrected, it is usually submitted to a partner for final reading and signature.

.15 Some firms do not bind the report until after it is signed. This saves unbinding in case the signing partner orders any revisions. In offices where the reports have been sufficiently and systematically reviewed and referenced before or after typing, they may be submitted to the partner for his signature in final bound form. This saves time and additional handling.

.16 The transmittal letters and addressed envelopes should be submitted to the partner with the reports. This gives him an opportunity to review the mailing directions, so that reports are directed to the proper person.

.17 Report letters are usually signed by a partner using the firm name. Where reproducing equipment is used, a signature on the original is sufficient. There is no complimentary closing. It is important to establish rules applying to report signatures since all reports (and correspondence) issued to clients carry with them the reputation, authority, and responsibility of the firm.

Delivery of Completed Work

.18 Audit reports are rightfully considered by clients to be confidential documents. For this reason, care should be taken to address them to a responsible person, usually the treasurer or principal executive, in an envelope clearly marked "confidential." Where there is some question as to the person or persons to whom the report should be delivered, address it to the specific source of authority authorizing the report. In a majority of cases, especially for recurring engagements, the reports are mailed. However, some firms make it a practice to have a partner deliver the report personally and discuss it with the client.

.19 The report should be mailed in envelopes or boxes sturdy enough to withstand the rough treatment they may receive in transit.

.20 Many firms send separate transmittal letters with their reports. The letter should contain no comments on the report because it might be construed as a modification of the opinion on the report. It is advisable to write a letter requesting that a printer's proof be submitted to the accounting firm for review before any printed reports are released by the client to stockholders or the public.

.21 Reports are generally issued only to the client who engaged the services. The unauthorized distribution of a report represents a violation of the confidential relationship between a firm and its client. Firms are sometimes asked by clients to mail copies of their reports directly to third parties. Clients should be discouraged from making such requests. In rare instances, where a firm assumes this added responsibility, distributions are made only upon specific written instruction from the client, and reference to the client's instructions should be included in the transmittal to the third party. Printed annual reports to shareholders, prospectuses, and other reports that are a matter of public record, such as those filed with certain governmental agencies, are obvious exceptions to this rule.

AAM Section 10,000

ACCOUNTANTS' REPORTS

These examples are for illustrative purposes only. They are included as conveniences for users of this manual who may want points of departure when drafting reports to meet their individual needs. This manual is a nonauthoritative kit of practice aids and accordingly, does not include extensive explanation or discussion of authoritative pronouncements. Users of this manual are urged to refer directly to applicable authoritative pronouncements when appropriate.

These examples illustrate the body of various reports. For comment on addressing and dating of the report, see section 10,100.

Examples which are assembled from illustrative reporting language set forth in Statements on Auditing Standards (SAS) and Statements on Standards for Accounting and Review Services (SSARS) include citation of the particular source and its location in *AICPA Professional Standards.*

TABLE OF CONTENTS

Section | Paragraph

[The next page is 10,101.]

AAM Section 10,100
Format of Accountants' Reports

Addressing the Report

.01 The accountant or auditor addresses his report to the client which retained his service.

.02 When the client is a corporation, the report may be addressed to the corporation, its board of directors or its stockholders. In practice, reports on financial statements of publicly traded corporations are usually addressed to the board of directors and stockholders.

.03 When the client is not incorporated, the circumstances will dictate how the report should be addressed. For example, the report may be addressed to the partners, to the general partner, or to the proprietor.

.04 Occasionally, an auditor is retained to audit the financial statements of an entity that is not his client. In such instances, the report is addressed to the client and not to the board of directors, stockholders or proprietor of the entity whose financial statements are being audited.

.05 For authoritative guidance on addressing the report, see SAS No. 58, paragraph 9 (AU section 508.09).

Dating the Report

.06 The date on an auditor's report generally indicates when the auditor completed the field work on which the report is based. Likewise, the date of an accountant's compilation report on the financial statements of a nonpublic entity, would be the date of completion of the compilation work. The date of a review report on such financial statements would be the date of completion of the accountant's inquiry and analytical procedures. Report dating involves additional considerations when the auditor becomes aware of events that occurred after completion of field work but before issuance of the report, when the report is on comparative financial statements, or when a report on prior year financial statements is reissued.

.07 When an event which is disclosed in the financial statements occurs after completion of field work but before issuance of the report, the auditor may use "dual dating," for example, "February 15, 19X1, except for Note 10 as to which the date is March 1, 19X1." In this instance, the auditor's responsibility for events occurring after February 15, 19X1 is limited to the specific event referred to in Note 10. The auditor may also date the report as of March 1, 19X1; this, however, would extend the auditor's responsibility for subsequent events to March 1, 19X1.

.08 For an auditor's report which covers financial statements of one or more prior periods (which he audited) presented on a comparative basis with those of the current period, the auditor would ordinarily date the report on the financial statements of all periods presented as of the date of his report on the most recent financial statements.

.09 When an auditor, as a predecessor, reissues a report on prior year financial statements for presentation with the report of a successor auditor on current year financial statements, the predecessor would use the date of his previous report on his reissued report to avoid the implication that he has performed any additional field work. If the predecessor auditor revises his report or if the financial statements are restated, he would dual date his report.

.10 For authoritative guidance on dating reports, see SAS No. 1, section 530; SAS No. 58, paragraphs 74 and 82; SAS No. 71, paragraph 27; and SSARS No. 1, paragraphs 15 and 33 (AU sections 530, 508.74 and .82, 722.27, and AR section 100.15 and .33, respectively).

[The next page is 10,211.]

AAM Section 10,210
Unqualified Opinions

.010 Auditor's Standard Report—Comparative Financial Statements

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with 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 X Company as of [at] December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraph 8 (AU section 508.08).]

.020 Auditor's Standard Report—Single Year Financial Statements

Independent Auditor's Report

Addressee:

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

We conducted our audit in accordance with 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 X Company as of [at] December 31, 19XX, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraph 8 (AU section 508.08).]

.030 Report on a Single Statement Audit (Balance Sheet Only Presented)

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 19XX. 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 X Company as of December 31, 19XX, in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraph 48 (AU section 508.48).]

.031 Report on Balance Sheet Only Audit When Other Financial Statements are Also Presented

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 19XX. 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 X Company as of December 31, 19XX, in conformity with generally accepted accounting principles.

Because we were not engaged to audit the statements of income, retained earnings, and cash flows, we did not extend our auditing procedures to enable us to express an opinion on the results of operations and cash flows for the year ended December 31, 19XX. Accordingly, we express no opinion on them.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraph 48 (AU section 508.48).]

.040 Reference to Other Auditors—Successor Auditor's Report When Predecessor's Report (Unqualified) Is Not Presented

Independent Auditor's Report

Addressee:

We have audited the balance sheet of ABC Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of ABC Company as of December 31, 19X1, were audited by other auditors whose report dated March 31, 19X2, 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 19X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of 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*]

[Source: SAS No. 58, paragraph 83 (AU section 508.83).]

.050 Reference to Other Auditors in Report

Independent Auditor's Report

Addressee:

We have audited the consolidated balance sheets of ABC Company as of December 31, 19X2 and 19X1, and the related consolidated statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of B Company, a wholly-owned subsidiary, which statements reflect total assets of $______ and $______ as of December 31, 19X2 and 19X1, respectively, and total revenues of $______ and $______ for the years then ended. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for B Company, is based solely on the report of the other auditors.

We conducted our audits in accordance with 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 other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and the report of other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraph 13 (AU section 508.13).]

.060 Reference to Other Auditors—Successor Auditor's Unqualified Report When Predecessor's Report That Included an Explanatory Paragraph Is Not Presented

Independent Auditor's Report

Addressee:

We have audited the balance sheet of ABC Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of ABC Company as of December 31, 19X1, were audited by other auditors whose report dated March 1, 19X2, on those statements included an explanatory paragraph that described the litigation discussed in Note X to the financial statements.

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 19X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of 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*]

[Source: SAS No. 58, paragraph 83 (AU section 508.83).]

.070 Reference to Other Auditors—Successor Auditor's Report When Prior Year Financial Statements Have Been Restated Following Issuance of the Predecessor's Report

Independent Auditor's Report

Addressee:

We have audited the balance sheet of ABC Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of ABC Company as of December 31, 19X1, before the restatement described in Note X, were audited by other auditors whose report dated March 31, 19X2, 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 19X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of 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.

We also reviewed the adjustments described in Note X that were applied to restate the 19X1 financial statements. In our opinion, such adjustments are appropriate and have been properly applied.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraph 83 (AU section 508.83).]

.080 Reference to Other Auditors—Prior Year Financial Statements Restated Following a Pooling of Interests

Independent Auditor's Report

Addressee:

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

We conducted our audit in accordance with 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 consolidated financial position of XYZ Company as of [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.

We previously audited and reported upon the consolidated statements of income and cash flows of XYZ Company and subsidiaries for the year ended December 31, 19X1, prior to their restatement for the 19X2 pooling of interests. The contribution of XYZ Company and subsidiaries to revenues and net income represented ______ percent and ______ percent of the respective restated totals. Separate financial statements of the other companies included in the 19X1 restated consolidated statements of income and cash flows were audited and reported upon separately by other auditors. We also have applied procedures to the combination of the accompanying consolidated statements of income and cash flows for the year ended December 31, 19X1, after restatement for the 19X2 pooling of interests; in our opinion, such consolidated statements have been properly combined on the basis described in Note A of notes to consolidated financial statements.

[*Signature*]

[*Date*]

[Source: SAS No. 1, section 543.16 as modified, October 1980, by the Auditing Standards Board (AU section 543.16).]

NOTE:

The auditor uses this form of reporting when he concludes he cannot serve as principal auditor for the restated financial statements.

.083 Reference to Other Auditors—Successor Auditor Report When Prior Period Financial Statements Were Audited by a Predecessor Auditor Who Has Ceased Operations

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of ABC Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of ABC Company as of December 31, 19X1, were audited by other auditors who have ceased operations and whose report dated March 31, 19X2, 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 19X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 19X2, and the results of operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraph 83 (AU section 508.83) and Notice to Practitioners, February 1991, *Audit, Review, and Compilation Considerations When a Predecessor Accountant Has Ceased Operations,* paragraph 6.]

.084 Reference to Other Auditors—Successor Auditor Report When Prior Period Financial Statements Were Audited By a Predecessor Auditor Who Has Ceased Operations Have Been Restated

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of ABC Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of ABC Company as of December 31, 19X1, before the restatement described in Note X, were audited by other auditors who have ceased operations and whose report dated March 31, 19X2, 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 19X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 19X2, and the results of operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

We also reviewed the adjustments described in Note X that were applied to restate the 19X1 financial statements. In our opinion, such adjustments are appropriate and have been properly applied.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraph 83 (AU section 508.83) and Notice to Practitioners, February 1991, *Audit, Review, and Compilation Considerations When a Predecessor Accountant Has Ceased Operations,* paragraphs 5 and 6.]

.085 Reference to Other Accountants—Report on Nonpublic Entity Presented With Prior Period Financial Statements Reviewed by a Predecessor Accountant Who Has Ceased Operations

Independent Auditor's Report

Addressee:

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

We conducted our audit in accordance with 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 19X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 19X2, and the results of operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

The 19X1 financial statements were reviewed by other accountants who have ceased operations, and their report thereon, dated March 1, 19X2, 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. However, a review is substantially less in scope than an audit and does not provide a basis for the expression of any opinion on the financial statements taken as a whole.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraph 83 (AU section 508.83) and Notice to Practitioners, February 1991, *Audit, Review, and Compilation Considerations When a Predecessor Accountant Has Ceased Operations,* paragraph 7.]

.086 Reference to Other Accountants—Report on Nonpublic Entity Presented With Prior Period Financial Statements Compiled by a Predecessor Accountant Who Has Ceased Operations

Independent Auditor's Report

Addressee:

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

We conducted our audit in accordance with 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 managements, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

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

The 19X1 financial statements were compiled by other accountants who have ceased operations, and their report thereon, dated February 1, 19X2, stated that they did not audit or review those financial statements and, accordingly, express no opinion or any other form of assurance on them.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraph 83 (AU section 508.83) and Notice to Practitioners, February 1991, *Audit, Review, and Compilation Considerations When a Predecessor Accountant Has Ceased Operations,* paragraph 7.]

.090 Change in Accounting Principles or Method of Accounting

Independent Auditor's Report

Addressee:

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

We conducted our audit in accordance with 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 X Company as of [at] December 31, 19XX, 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 to the financial statements, the Company changed its method of computing depreciation in 19XX.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraph 35 (AU section 508.35).]

.100 Uncertainty—Litigation

Independent Auditor's Report

Addressee:

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

We conducted our audit in accordance with 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 X Company as of [at] December 31, 19XX, 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 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.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraph 32 (AU section 508.32).]

.110 Going Concern—Uncertainty

Independent Auditor's Report

Addressee:

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

We conducted our audit in accordance with 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 X Company as of [at] December 31, 19XX, and the results of its operations and its cash flows for the year 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 raise substantial doubt about its ability to continue as a going concern. Management's plans in regard to these matters are also described in Note X. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

[*Signature*]

[*Date*]

[Source: SAS No. 59, paragraph 13 (AU section 341.13).]

.120 Liquidation Basis Accounting—Uncertainty Regarding Realization of Assets and Settlement of Obligations

Independent Auditor's Report

Addressee:

We have audited the statement of net assets in liquidation of XYZ Company as of December 31, 19X2, and the related statement of changes in net assets in liquidation for the period from April 26, 19X2 to December 31, 19X2. In addition, we have audited the statements of income, retained earnings, and cash flows for the period from January 1, 19X2 to April 25, 19X2. 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 net assets in liquidation as of December 31, 19X2, and the changes in its net assets in liquidation for the period from April 26, 19X2 to December 31, 19X2, and the results of its operations and its cash flows for the period from January 1, 19X2 to April 25, 19X2, in conformity with generally accepted accounting principles applied on the bases described in the following paragraph.

As described in Note X to the financial statements, the stockholders of XYZ Company approved a plan of liquidation on April 25, 19X2, and the company commenced liquidation shortly thereafter. As a result, the company has changed its basis of accounting for periods subsequent to April 25, 19X2 from the going-concern basis to a liquidation basis. It is not presently determinable whether the amounts realizable from the disposition of the remaining assets or the amounts that creditors agree to accept in settlement of the obligations due them will differ materially from the amounts shown in the accompanying financial statements.

[*Signature*]

[*Date*]

[Source: Interpretation No. 8 of SAS No. 58 (AU section 9508.36 and .38).]

.130 Liquidation Basis of Accounting—Single Year Financial Statements

Independent Auditor's Report

Addressee:

We have audited the accompanying statement of net assets in liquidation of X Company as of December 31, 19X2, and the related statement of changes in net assets in liquidation for the period from April 26, 19X2 to December 31, 19X2. In addition, we have audited the statements of income, retained earnings, and cash flows for the period from January 1, 19X2 to April 25, 19X2. 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 net assets in liquidation of X Company as of December 31, 19X2, the changes in its net assets in liquidation for the period from April 26, 19X2 to December 31, 19X2, and the results of its operations and its cash flows for the period from January 1, 19X2 to April 25, 19X2, in conformity with generally accepted accounting principles applied on the bases described in the following paragraph.

As described in Note X to the financial statements, the stockholders of X Company approved a plan of liquidation on April 25, 19X2, and the company commenced liquidation shortly thereafter. As a result, the company has changed its basis of accounting for periods subsequent to April 25, 19X2 from the going-concern basis to a liquidation basis.

[*Signature*]

[*Date*]

[Source: Interpretation No. 8 of SAS No. 58 (AU section 9508.36).]

.140 Liquidation Basis of Accounting—Comparative Financial Statements

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 19X1, and the related statements of income, retained earnings, and cash flows for the year then ended, and the statements of income, retained earnings, and cash flows for the period from January 1, 19X2 to April 25, 19X2. In addition, we have audited the statement of net assets in liquidation as of December 31, 19X2, and the related statement of changes in net assets in liquidation for the period from April 26, 19X2 to December 31, 19X2. 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 X Company as of December 31, 19X1, and the results of its operations and its cash flows for the year then ended and for the period from January 1, 19X2 to April 25, 19X2, its net assets in liquidation, as of December 31, 19X2, and the changes in its net assets in liquidation for the period from April 26, 19X2 to December 31, 19X2, in conformity with generally accepted accounting principles applied on the bases described in the following paragraph.

As described in Note X to the financial statements, the stockholders of X Company approved a plan of liquidation on April 25, 19X2, and the company commenced liquidation shortly thereafter. As a result, the company has changed its basis of accounting for periods subsequent to April 25, 19X2 from the going-concern basis to a liquidation basis.

[*Signature*]

[*Date*]

[Source: Interpretation No. 8 of SAS No. 58 (AU section 9508.36).]

.150 Comparative Financial Statements—Unqualified Opinion on the Current Year's Financial Statements With Disclaimer of Opinion on the Prior Year's Statements of Income, Retained Earnings, and Cash Flows

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

We did not observe the taking of the physical inventory as of December 31, 19X0, 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, 19X0, enter into the determination of net income and cash flows for the year ended December 31, 19X1.

Because of the matter discussed in the preceding paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the results of operations and cash flows for the year ended December 31, 19X1.

In our opinion, the balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the year ended December 31, 19X2, present fairly, in all material respects, the financial position of X Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the year ended December 31, 19X2, in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraph 76 (AU section 508.76).]

NOTE:

This report assumes that the independent auditor has been able to satisfy himself as to the consistency of application of generally accepted accounting principles.

.160 Comparative Financial Statements—Subsequent Restatement of Prior-Period Financial Statements to Conform With Generally Accepted Accounting Principles

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with 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 March 1, 19X2, we expressed an opinion that the 19X1 financial statements did not fairly present financial position, results of operations, and cash flows in conformity with generally accepted accounting principles because of two departures from such principles: (1) the Company carried its property, plant, and equipment at appraisal values, and provided for depreciation on the basis of such values, and (2) the Company did not provide for deferred income taxes with respect to differences between income for financial reporting purposes and taxable income. As described in Note X, the Company has changed its method of accounting for these items and restated its 19X1 financial statements to conform with generally accepted accounting principles. Accordingly, our present opinion on the 19X1 financial statements, as presented herein, is different from that expressed in our previous report.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraph 78 (AU section 508.78).]

.170 Comparative Financial Statements—Current Year's Statements Audited and Prior Year's Statements Reviewed

Independent Auditor's Report

Addressee:

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

We conducted our audit in accordance with 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 X Company as of 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.

The 19X1 financial statements were reviewed by us (other accountants) and our (their) report thereon, dated March 1, 19X2, stated we (they) were not aware of any material modifications that should be made to those statements for them to be in conformity with generally accepted accounting principles. However, a review is substantially less in scope than an audit and does not provide a basis for the expression of an opinion on the financial statements taken as a whole.

[*Signature*]

[*Date*]

[Source: SAS No. 26, paragraph 17 (AU section 504.17).]

NOTE:

When unaudited financial statements are presented in comparative form with audited financial statements, the unaudited financial statements should be clearly marked to indicate their status.

.180 Comparative Financial Statements—Current Year's Statements Audited and Prior Year's Statements Compiled

Independent Auditor's Report

Addressee:

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

We conducted our audit in accordance with 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 X Company as of 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.

The 19X1 financial statements were compiled by us (other accountants) and our (their) report thereon, dated March 1, 19X2, stated we (they) did not audit or review those financial statements and, accordingly, express no opinion or other form of assurance on them.

[*Signature*]

[*Date*]

[Source: SAS No. 26, paragraph 17 (AU Section 504.17).]

NOTE:

When unaudited financial statements are presented in comparative form with audited financial statements, the unaudited financial statements should be clearly marked to indicate their status.

.190 Comparative Financial Statements—Current Year's Statements Audited and Disclaimer on Prior Year's Unaudited Statements

Independent Auditor's Report

Addressee:

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

We conducted our audit in accordance with 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 X Company as of 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.

The 19X1 financial statements were not audited by us and, accordingly, we do not express an opinion on them.

[*Signature*]

[*Date*]

NOTES:

The above report illustrates a disclaimer of opinion as described in SAS No. 26, paragraph 17 (AU section 504.17) when the financial statements are those of a public entity. For a nonpublic entity, see AAM section 10,210.170 and .180.

When unaudited financial statements are presented in comparative form with audited financial statements, the unaudited financial statements should be clearly marked to indicate their status.

.200 U.S.—Style Report Modified to Report on Financial Statements Prepared in Conformity With Accounting Principles Generally Accepted in Another Country That Are Intended for Use Only Outside the United States

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of the International Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended, which, as described in Note X, have been prepared on the basis of accounting principles generally accepted in [*name of country*]. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

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

[*Signature*]

[*Date*]

NOTE:

The above illustrates a report as described in SAS No. 51, paragraph 10 (AU section 534.10).

.210 Report on Financial Statements Prepared in Conformity With the Accounting Principles Generally Accepted in Another Country That Will Have More Than Limited Distribution in the United States

Independent Auditor's Report

Addressee:

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

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

As more fully described in Note X to the financial statements, the Company has recorded fixed assets in excess of historical cost using appraised value as the basis for adjustment in accordance with accounting principles generally accepted in [*name of country*]. If the fixed assets had been recorded at historical cost, fixed assets and retained earnings would be decreased by $XXX,XXX and $XXX,XXX respectively, as of December 31, 19XX, and net income and earnings per share would be increased by $X,XXX and $X.XX respectively for the year then ended.

In our opinion, except for the effects of recording the fixed assets in excess of historical costs, discussed in the preceding paragraph, the financial statements present fairly, in all material respects, the financial position of the International Company as of December 31, 19XX, and the results of its operations and the cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States.

(Optional Paragraph)

In our opinion, the financial statements referred to above present fairly the financial position of the International Company at December 31, 19XX, and the results of its operations and its cash flows for the year then ended, in conformity with accounting principles generally accepted in [*name of country*].

[*Signature*]

[*Date*]

NOTE:

The above illustrates a report as described in SAS No. 51, paragraphs 14-15 (AU section 534.14-.15).

.220 Correction of an Error, Not Involving an Accounting Principle

Independent Auditor's Report

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with 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 misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2 and 19X1, 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 2 to the financial statements, certain errors resulting in an understatement of previously reported expenses for the years ended December 31, 19X1 and 19X0 were discovered by the Company's management during the current year. Accordingly, the 19X1 financial statements have been restated and an adjustment has been made to the retained earnings as of January 1, 19X1 to correct the errors.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraph 8 and SAS No. 1, section 420, paragraph 11 (AU sections 508.08 and 420.11, respectively).]

(Note: This report would be used when the issuance of financial statements accompanied by the auditor's report for a subsequent period is imminent so that disclosure is not delayed.)

.230 Subsequent Event Prior to Issuance of Auditor's Report

Independent Auditor's Report

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with 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 misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2 and 19X1, 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 12 to the financial statements, on March 1, 19X3, the Company entered into an agreement to sell Subsidiary A. This Subsidiary represents X% of the Company's total assets and X% of its revenues.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraphs 8 and 37 (AU section 508.08 and .37).]

.240 Reissued Report Due to Subsequent Discovery of Facts Existing at the Date of the Auditor's Report

Independent Auditor's Report

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with 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 misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2 and 19X1, 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 10 to the financial statements, the Company's 19X2 [*specify account corrected*] previously reported as $XX,XXX should have been $X,XXX. This discovery was made subsequent to the issuance of the financial statements. The financial statements have been restated to reflect this correction.

[*Signature*]

[*March 31, 19X3, except for Note 10, as to which the date is April 30, 19X3*]

[Source: SAS No. 1, section 561, paragraph 6a and SAS No. 58, paragraph 8 (AU sections 561.06a and 508.08, respectively).]

[The next page is 10,271.]

AAM Section 10,220
Adverse Opinions

.01 Departures from GAAP

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with 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 income taxes with respect to differences between financial income and taxable income arising because of the use, for income tax purposes, of the installment method of reporting gross profit from certain types of sales. 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, 19X2 and 19X1, inventories have been increased $______ and $______ by inclusion in manufacturing overhead of depreciation in excess of that based on cost; property, plant, and equipment, less accumulated depreciation, is carried at $______ and $______ in excess of an amount based on the cost to the Company; and deferred income taxes of $______ and $______ have not been recorded, resulting in an increase of $______ and $______ in retained earnings and in appraisal surplus of $______ and $______, respectively. For the years ended December 31, 19X2 and 19X1, cost of goods sold has been increased $______ and $______, respectively, because of the effects of the depreciation accounting referred to above and deferred income taxes of $______ and $______ have not been provided, resulting in an increase in net income of $______ and $______, respectively.

In our opinion, because of the effects of the matters discussed in the preceding paragraphs, the financial statements referred to above do not present fairly, in conformity with generally accepted accounting principles, the financial position of X Company as of December 31, 19X2 and 19X1, or the results of its operations or its cash flows for the years then ended.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraph 69 (AU section 508.69).]

[The next page is 10,321.]

AAM Section 10,230
Disclaimers of Opinion

.01 Beginning Inventory Not Observed (First Examination)

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 19X2, and were engaged to audit the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

Except as discussed in the following paragraph, 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.

Because we were not engaged as auditors until after December 31, 19X1, we were not present to observe the physical inventory taken at that date and we have not satisfied ourselves by means of other procedures concerning inventory quantities. The amount of the inventory at December 31, 19X1, enters materially into the determination of the results of operations and cash flows for the year ended December 31, 19X2. Therefore, we do not express an opinion on the accompanying statements of income, retained earnings and cash flows for the year ended December 31, 19X2.

In our opinion, the balance sheet referred to above presents fairly, in all material respects, the financial position of X Company as of December 31, 19X2, in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraph 44 (AU section 508.44).]

.02 Inability to Obtain Sufficient Competent Evidential Matter Due to a Scope Limitation

Independent Auditor's Report

Addressee:

We were engaged to audit the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management.

The Company did not make a count of its physical inventory in 19X2 or 19X1, stated in the accompanying financial statements at $_____ as of December 31, 19X2, and at $_____ as of December 31, 19X1. Further, evidence supporting the cost of property and equipment acquired prior to December 31, 19X1, is no longer available. The Company's records do not permit the application of other auditing procedures to inventories or property and equipment.

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

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraph 72 (AU section 508.72).]

.03 Scope Limitation—Inventory and GAAP Departure—Capitalized Lease Obligations

Independent Auditor's Report

Addressee:

We were engaged to audit the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management.

The Company has excluded, from property and debt in the accompanying balance sheets, certain lease obligations that, in our opinion, should be capitalized in order to conform with 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, 19X2 and 19X1, respectively. Additionally, net income would be increased (decreased) by $______ and $______ and earnings per share would be increased (decreased) by $______ and $______, respectively, for the years then ended.

The Company did not make a count of its physical inventory in 19X2 or 19X1, stated in the accompanying financial statements at $______ as of December 31, 19X2, and at $______ as of December 31, 19X1. Further, evidence supporting the cost of property and equipment acquired prior to December 31, 19X1, is no longer available. The Company's records do not permit the application of other auditing procedures to inventories or property and equipment.

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

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraph 72 (AU section 508.72).]

NOTE:

This report would be used if the GAAP departure is not so material to require an adverse opinion. See AAM section 10,220.01 for an example of an adverse opinion.

[The next page is 10,371.]

AAM Section 10,240
Qualified Opinions

.010 Scope Limitation—Investment in Foreign Affiliate (Assuming Effects Are Such That Qualification Rather Than Disclaimer Is Appropriate)

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as discussed in the following paragraph, we conducted our audits in accordance with 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, 19X2 and 19X1, respectively, or its equity in earnings of that affiliate of $______ and $______, which is included in net income for the years then ended as described in Note X to the financial statements; nor were we able to satisfy ourselves as to the carrying value of the investment in the foreign affiliate or the equity in its earnings by other auditing procedures.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding the foreign affiliate investment and earnings, the financial statements referred to in the first paragraph above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraph 44 (AU section 508.44).]

.020 Departure from GAAP—Leases Not Capitalized

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with 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 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, 19X2 and 19X1, respectively. Additionally, net income would be increased (decreased) by $______ and $______ and earnings per share would be increased (decreased) by $______ and $______, respectively, for the years then ended.

In our opinion, except for the effects of not capitalizing certain lease obligations as discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraph 53 (AU section 508.53).]

.030 Departure from GAAP—Leases Not Capitalized—Pertinent Facts Disclosed in Note

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with 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 more fully described in Note X to the financial statements, the Company has excluded certain lease obligations from property and debt in the accompanying balance sheets. In our opinion, generally accepted accounting principles require that such obligations be included in the balance sheets.

In our opinion, except for the effects of not capitalizing certain lease obligations as discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraph 54 (AU section 508.54).]

.040 Inadequate Disclosure—Omission of Disclosures

Independent Auditor's Report

Addressee:

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

We conducted our audit in accordance with 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.

The Company's financial statements do not disclose [*describe the nature of the omitted disclosures*]. In our opinion, disclosure of this information is required by generally accepted accounting principles.

In our opinion, except for the omission of the information discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 19XX, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraph 56 (AU section 508.56).]

.050 Inadequate Disclosure—Omission of Statement of Cash Flows

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income and retained earnings for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audits in accordance with 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, 19X2 and 19X1. 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 X Company as of December 31, 19X2 and 19X1, and the results of its operations for the years then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraph 58 (AU section 508.58).]

.060 Change in Accounting Principle Without Reasonable Justification

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with 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 19X2, 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 X Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraph 61 (AU section 508.61).]

NOTE:

If the change was from an accounting principle that is not generally accepted to one that is generally accepted it would be a correction of an error and would require recognition in the auditor's report as to consistency. However, because the middle paragraph contains all of the information required in an explanatory paragraph (following the opinion paragraph) as required by SAS No. 58, paragraphs 34-36 (AU section 508.34-.36) an explanatory paragraph is not required in this instance.

.070 Change to an Accounting Principle Not in Conformity With Generally Accepted Accounting Principles

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with 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 previously recorded its land at cost but adjusted the amounts to appraised values during the year, with a corresponding increase in stockholders' equity in the amount of $______. In our opinion, the new basis on which land is recorded is not in conformity with generally accepted accounting principles.

In our opinion, except for the change to recording appraised values as described above, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraph 64 (AU section 508.64).]

.080 More than One Reason—Qualified Opinion on Prior Year's Financial Statements With the Current Year Qualified for the Same Reason and an Additional Reason

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as discussed in the following paragraph, we conducted our audits in accordance with 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, 19X2 and 19X1, respectively, or its equity in earnings of that affiliate of $______ and $______, which is included in net income for the years then ended as described in Note X to the financial statements; nor were we able to satisfy ourselves as to the carrying value of the investment in the foreign affiliate or the equity in its earnings by other auditing procedures.

The Company has excluded, from property and debt in the accompanying 19X2 balance sheet, certain lease obligations that were entered into in 19X2, which 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 $______, long-term debt by $______, and retained earnings by $______, as of December 31, 19X2. Additionally, net income would be increased (decreased) by $______ and earnings per share would be increased (decreased) by $______ for the year then ended.

In our opinion, except for the effects on the 19X2 and 19X1 financial statements of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding the foreign affiliate investment and earnings, and except for the effects on the 19X2 financial statements of not capitalizing certain lease obligations as discussed in the preceding paragraph, the financial statements referred to in the the first paragraph above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraphs 44 and 53 (AU section 508.44 and .53).]

[The next page is 10,421.]

AAM Section 10,245
Information Accompanying Audited Financial Statements

.010 Omission of Supplementary Information Required by the FASB

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with 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 X Company as of [at] December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

The Company has not presented [*describe the supplementary information required by the FASB in the circumstances*] that the Financial Accounting Standards Board has determined is necessary to supplement, although not required to be part of, the basic financial statements.

[*Signature*]

[*Date*]

[Source: SAS No. 52, paragraph 2 (AU section 558.08).]

.015 Omission of Supplementary Information Required by the GASB

Independent Auditor's Report

Addressee:

We have audited the accompanying general purpose financial statements of City of Example, Any State as of December 31, 19XX, and for the year then ended. These general purpose financial statements are the responsibility of City of Example, Any State 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 general purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State as of December 31, 19XX, and the results of its operations and changes in financial position of its proprietary fund types for the year then ended in conformity with generally accepted accounting principles.

The City of Example, Any State has not presented [*describe the supplementary information required by the GASB in the circumstances*] that the Governmental Accounting Standards Board has determined is necessary to supplement, although not required to be part of, the basic financial statements.

[*Signature*]

[*Date*]

[Source: SAS No. 52, paragraph 2 (AU section 558.08).]

.020 Material Departures From FASB Guidelines on Supplementary Information

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with 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 X Company as of [at] December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

The [*specifically identify the supplementary information*] on page XX is not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. However, we have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. As a result of such limited procedures, we believe that the [*specifically identify the supplementary information*] is not in conformity with guidelines established by the Financial Accounting Standards Board because [*describe the material departure(s) from the FASB guidelines*].

[*Signature*]

[*Date*]

[Source: SAS No. 52, paragraph 2 (AU section 558.08).]

NOTE:

Ordinarily, the required supplementary information should be distinct from the audited financial statements and distinguished from other information outside the financial statements that is not required by the FASB. However, management may choose not to place the required supplementary information outside the basic financial statements. In such circumstances, the information should be clearly marked as unaudited. If the information is not clearly marked as unaudited, the auditor's report on the audited financial statements should be expanded to include a disclaimer on the supplementary information. (See AAM section 10,245.060)

.025 Material Departures From GASB Guidelines on Supplementary Information

Independent Auditor's Report

Addressee:

We have audited the accompanying general purpose financial statements of City of Example, Any State as of December 31, 19XX, and for the year then ended. These general purpose financial statements are the responsibility of City of Example, Any State 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 general purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State as of December 31, 19XX, and the results of its operations and changes in financial position of its proprietary fund types for the year then ended in conformity with generally accepted accounting principles.

The [*specifically identify the supplementary information*] on page XX is not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. However, we have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. As a result of such limited procedures, we believe that the [*specifically identify the supplementary information*] is not in conformity with guidelines established by the Governmental Accounting Standards Board because [*describe the material departure(s) from the GASB guidelines*].

[*Signature*]

[*Date*]

[Source: SAS No. 52, paragraph 2 (AU section 558.08).]

NOTE:

Ordinarily, the required supplementary information should be distinct from the audited financial statements and distinguished from other information outside the financial statements that is not required by the GASB. However, management may choose not to place the required supplementary information outside the basic financial statements. In such circumstances, the information should be clearly marked as unaudited. If the information is not clearly marked as unaudited, the auditor's report on the audited financial statements should be expanded to include a disclaimer on the supplementary information. (See AAM section 10,245.060)

.030 Prescribed Procedures Not Completed Regarding Supplementary Information Required by the FASB

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with 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 X Company as of [at] December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

The [*specifically identify the supplementary information*] on page XX is not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. Further, we were unable to apply to the information certain procedures prescribed by professional standards because [*state the reasons*].

[*Signature*]

[*Date*]

[Source: SAS No. 52, paragraph 2 (AU section 558.08).]

NOTES:

Even though he is unable to complete the prescribed procedures, if, on the basis of facts known to him, the auditor concludes that the supplementary information has not been measured or presented within prescribed guidelines, he should suggest appropriate revision; failing that, he describes the nature of any material departure(s) in his report.

Ordinarily, the required supplementary information should be distinct from the audited financial statements and distinguished from other information outside the financial statements that is not required by the FASB. However, management may choose not to place the required supplementary information outside of the basic financial statements. In such circumstances, the information should be clearly marked as unaudited. If the information is not clearly marked as unaudited, the auditor's report should be expanded to include a disclaimer on the supplementary information. (See AAM section 10,245.060)

.035 Prescribed Procedures Not Completed Regarding Supplementary Information Required by the GASB

Independent Auditor's Report

Addressee:

We have audited the accompanying general purpose financial statements of City of Example, Any State as of December 31, 19XX, and for the year then ended. These general purpose financial statements are the responsibility of City of Example, Any State 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 general purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State as of December 31, 19XX, and the results of its operations and changes in financial position of its proprietary fund types for the year then ended in conformity with generally accepted accounting principles.

The [*specifically identify the supplementary information*] on page XX is not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. Further, we were unable to apply to the information certain procedures prescribed by professional standards because [*state the reasons*].

[*Signature*]

[*Date*]

[Source: SAS No. 52, paragraph 2 (AU section 558.08).]

NOTES:

Even though he is unable to complete the prescribed procedures, if, on the basis of facts known to him, the auditor concludes that the supplementary information has not been measured or presented within prescribed guidelines, he should suggest appropriate revision; failing that, he should describe the nature of any material departure(s) in his report.

Ordinarily, the required supplementary information should be distinct from the audited financial statements and distinguished from other information outside the financial statements that is not required by the FASB. However, management may choose not to place the required supplementary information outside of the basic financial statements. In such circumstances, the information should be clearly marked as unaudited. If the information is not clearly marked as unaudited, the auditor's report should be expanded to include a disclaimer on the supplementary information. (See AAM section 10,245.060)

.040 Unresolved Doubts About Adherence to Guidelines Regarding Supplementary Information Required by FASB

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with 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 X Company as of [at] December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

The [*specifically identify the supplementary information*] on page XX is not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. However, we have applied certain limited procedures prescribed by professional standards that raised doubts that we were unable to resolve regarding whether material modifications should be made to the information for it to conform with guidelines established by the Financial Accounting Standards Board. [*The auditor should consider including in his report the reason(s) he was unable to resolve his substantial doubts.*]

[*Signature*]

[*Date*]

[Source: SAS No. 52, paragraph 2 (AU section 558.08).]

NOTES:

Even though he is unable to complete the prescribed procedures, if, on the basis of facts known to him, the auditor concludes that the supplementary information has not been measured or presented within prescribed guidelines, he should suggest appropriate revision; failing that, he describes the nature of any material departure(s) in his report.

Ordinarily, the required supplementary information should be distinct from the audited financial statements and distinguished from other information outside the financial statements that is not required by the FASB. However, management may choose not to place the required supplementary information outside of the basic financial statements. In such circumstances, the information should be clearly marked as unaudited. If the information is not clearly marked as unaudited, the auditor's report should be expanded to include a disclaimer on the supplementary information. (See AAM section 10,245.060)

.045 Unresolved Doubts About Adherence to Guidelines Regarding Supplementary Information Required by GASB

Independent Auditor's Report

Addressee:

We have audited the accompanying general purpose financial statements of City of Example, Any State as of December 31, 19XX, and for the year then ended. These general purpose financial statements are the responsibility of City of Example, Any State 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 general purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State as of December 31, 19XX, and the results of its operations and changes in financial position of its proprietary fund types for the year then ended in conformity with generally accepted accounting principles.

The [*specifically identify the supplementary information*] on page XX is not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. However, we have applied certain limited procedures prescribed by professional standards that raised doubts that we were unable to resolve regarding whether material modifications should be made to the information for it to conform with guidelines established by the Governmental Accounting Standards Board. [*The auditor should consider including in his report the reason(s) he was unable to resolve his substantial doubts.*]

[*Signature*]

[*Date*]

[Source: SAS No. 52, paragraph 2 (AU section 558.08).]

NOTES:

Even though he is unable to complete the prescribed procedures, if, on the basis of facts known to him, the auditor concludes that the supplementary information has not been measured or presented within prescribed guidelines, he should suggest appropriate revision; failing that, he describes the nature of any material departure(s) in his report.

Ordinarily, the required supplementary information should be distinct from the audited financial statements and distinguished from other information outside the financial statements that is not required by the FASB. However, management may choose not to place the required supplementary information outside of the basic financial statements. In such circumstances, the information should be clearly marked as unaudited. If the information is not clearly marked as unaudited, the auditor's report should be expanded to include a disclaimer on the supplementary information. (See AAM section 10,245.060)

.050 Report on Accompanying Information

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with 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 X Company as of [at] December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

Our audits were made for the purpose of forming an opinion on the basic financial statements taken as a whole. The (identify accompanying information) is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature*]

[*Date*]

[Source: SAS No. 29, paragraph 12 (AU section 551.12).]

NOTES:

The report on the accompanying information may be added to the auditor's standard report on the basic financial statements or may appear separately in the auditor-submitted document.

This form of reporting on accompanying information is not appropriate with respect to supplementary information required by the FASB; see SAS No. 52, paragraph 3 (AU section 551.15).

.060 Disclaimer on Accompanying Information (Not Audited)

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with 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 X Company as of [at] December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

Our audits were made for the purpose of forming an opinion on the basic financial statements taken as a whole. The (identify the accompanying information) is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has not been subjected to the auditing procedures applied in the audit of the basic financial statements, and, accordingly, we express no opinion on it.

[*Signature*]

[*Date*]

[Source: SAS No. 29, paragraph 13 (AU section 551.13).]

NOTES:

The report on the accompanying information may be added to the auditor's standard report on the basic financial statements or may appear separately in the auditor-submitted document.

When the auditor disclaims an opinion on all or part of the accompanying information in a document that he submits to his client or to others, such information should either be marked as unaudited or should include a reference to the auditor's disclaimer of opinion. The wording of the disclaimer will vary according to the circumstances.

.070 Disclaimer on Part of the Accompanying Information (Not Audited)

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with 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 X Company as of [at] December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

Our audits were made for the purpose of forming an opinion on the basic financial statements taken as a whole. The information on pages XX-YY is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information, except for that portion marked "unaudited," on which we express no opinion, has been subjected to the auditing procedures applied in the audit of the basic financial statements; and, in our opinion, the information is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature*]

[*Date*]

[Source: SAS No. 29, paragraph 13 (AU section 551.13).]

NOTES:

The report on the accompanying information may be added to the auditor's standard report on the basic financial statements or may appear separately in the auditor-submitted document.

When the auditor disclaims an opinion on all or part of the accompanying information in a document that he submits to his client or to others, such information should either be marked as unaudited or should include a reference to the auditor's disclaimer of opinion. The wording of the disclaimer will vary according to the circumstances.

.080 Qualification on Basic Financial Statements and Accompanying Information (Departure From GAAP)

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with 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 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, 19X2 and 19X1, respectively. Additionally, net income would be increased (decreased) by $______ and $______ and earnings per share would be increased (decreased) by $______ and $______, respectively, for the years then ended.

In our opinion, except for the effects of not capitalizing certain lease obligations as discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

Our audits were made for the purpose of forming an opinion on the basic financial statements taken as a whole. The schedules of property and related depreciation (page X), and long-term debt with related interest (page Y), as of December 31, 19X2, are presented for purposes of additional analysis and are not a required part of the basic financial statements. The information in such schedules has been subjected to the auditing procedures applied in the audit of the basic financial statements; and, in our opinion, except for the effects on the schedule of property of not capitalizing certain lease obligations as explained in the third paragraph of this report, such information is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature*]

[*Date*]

[Source: SAS No. 29, paragraph 14 and SAS No. 58, paragraph 53 (AU sections 551.14 and 508.53).]

NOTE:

The report on the accompanying information may be added to the auditor's report on the basic financial statements or may appear separately in the auditor-submitted document.

.090 Supplementary Information Required by the FASB Included in Auditor-Submitted Document

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with 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 X Company as of [at] December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

The [*identify the supplementary information*] on page XX is not a required part of the basic financial statements but is supplementary information required by the Financial Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

[*Signature*]

[*Date*]

[Source: SAS No. 52, paragraph 3 (AU section 551.15).]

NOTES:

The report on the accompanying information may be added to the auditor's standard report on the basic financial statements or may appear separately in the auditor-submitted documents.

When supplementary information required by the FASB is presented outside the basic financial statements in an auditor-submitted document, the auditor should disclaim an opinion on the information unless he has been engaged to perform an audit and express an opinion on it.

In accordance with SAS No. 52, paragraph 2 (AU section 558.08), the auditor's report should be expanded in certain circumstances. The illustrative reports at AAM section 10,245.010—.045 are assembled from illustrative reporting language in SAS No. 52, paragraph 2 (AU section 558.08).

.095 Supplementary Information Required by GASB Included in Auditor-Submitted Documents

Independent Auditor's Report

Addressee:

We have audited the accompanying general purpose financial statements of City of Example, Any State as of December 31, 19XX, and for the year then ended. These general purpose financial statements are the responsibility of City of Example, Any State 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 general purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State as of December 31, 19XX, and the results of its operations and changes in financial position of its proprietary fund types for the year then ended in conformity with generally accepted accounting principles.

The [*identify the supplementary information*] on page XX is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

[*Signature*]

[*Date*]

[Source: SAS No. 52, paragraph 3 (AU section 551.15).]

NOTES:

The report on the accompanying information may be added to the auditor's standard report on the basic financial statements or may appear separately in the auditor-submitted documents.

When supplementary information required by the GASB is presented outside the basic financial statements in an auditor-submitted document, the auditor should disclaim an opinion on the information unless he has been engaged to audit and express an opinion on it.

In accordance with SAS No. 52, paragraph 2 (AU section 558.08), the auditor's report should be expanded in certain circumstances. The illustrative reports at AAM section 10,245.010—.045 are assembled from illustrative reporting language in SAS No. 52, paragraph 2 (AU section 558.08).

.100 Consolidating Information Not Separately Examined

Independent Auditor's Report

Addressee:

We have audited the accompanying consolidated balance sheets of X Company and subsidiaries as of December 31, 19X2 and 19X1, and the related consolidated statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with 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 consolidated financial statements referred to above present fairly, in all material respects, the financial position of X Company and subsidiaries as of [at] December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

Our audits were made for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The consolidating information is presented for purposes of additional analysis of the consolidated financial statements rather than to present the financial position, results of operations, and cash flows of the individual companies. The consolidating information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and, in our opinion, is fairly stated in all material respects in relation to the consolidated financial statements taken as a whole.

[*Signature*]

[*Date*]

[Source: SAS No. 29, paragraph 18 (AU section 551.18).]

NOTES:

The report on the consolidating information may be added to the auditor's standard report on the basic financial statements or may appear separately in the auditor-submitted document.

When the auditor is engaged to express an opinion only on the consolidated financial statements and consolidating information is also included, the auditor should be satisfied that the consolidating information is suitably identified. For example, when the consolidated financial statements include columns of information about the components of the consolidated group, the balance sheets might be titled, "Consolidated Balance Sheet—December 31, 19X1, with Consolidating Information," and the columns including the consolidating information might be marked, "Consolidating Information." When the consolidating information is presented in separate schedules, the schedules presenting balance sheet information of the components might be titled, for example, "Consolidating Schedule, Balance Sheet Information, December 31, 19X1."

.110 Unqualified Opinion on Selected Financial Data in a Client-Prepared Document That Includes Audited Financial Statements

Independent Auditor's Report

Addressee:

We have audited the accompanying consolidated balance sheets of X Company and subsidiaries as of December 31, 19X5 and 19X4, and the related consolidated statements of income, retained earnings, and cash flows for each of the three years in the period ended December 31, 19X5. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our 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 consolidated financial statements referred to above present fairly, in all material respects, the financial position of X Company and subsidiaries as of December 31, 19X5 and 19X4, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 19X5 in conformity with generally accepted accounting principles.

We have also previously audited, in accordance with generally accepted auditing standards, the consolidated balance sheets as of December 31, 19X3, 19X2, and 19X1, and the related consolidated statements of income, retained earnings, and cash flows for the years ended December 31, 19X2 and 19X1 (none of which are presented herein); and we expressed unqualified opinions on those consolidated financial statements. In our opinion, the information set forth in the selected financial data for each of the five years in the period ended December 31, 19X5, appearing on page XX, is fairly stated in all material respects in relation to the consolidated financial statements from which it has been derived.

[*Signature*]

[*Date*]

[Source: SAS No. 42, paragraph 10 (AU section 552.10).]

[The next page is 10,471.]

AAM Section 10,250

Engagements to Report on Internal Accounting Control

.010 Unqualified Opinion on Management's Assertion About the Effectiveness of an Entity's Internal Control Structure When Management's Assertion is Presented in a Separate Report

Independent Accountant's Report

We have examined management's assertion [*identify management's assertion, for example, that W Company maintained an effective internal control structure over financial reporting as of December 31, 19XX*] included in the accompanying [*title of management report*].

Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of the internal control structure over financial reporting, testing, and evaluating the design and operating effectiveness of the internal control structure, and such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

Because of inherent limitations in any internal control structure, errors or irregularities may occur and not be detected. Also, projections of any evaluation of the internal control structure over financial reporting to future periods are subject to the risk that the internal control structure may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assertion [*identify management's assertion, for example, that W Company maintained an effective internal control structure over financial reporting as of December 31, 19XX*] is fairly stated, in all material respects, based upon [*identify stated or established criteria*].[1]

[Source: SSAE No. 2, paragraph 51 (AT section 400.51).]

[1] For example, "criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)".

.020 Unqualified Opinion on Management's Assertion About the Effectiveness of an Entity's Internal Control Structure When Management's Assertion is Presented Only in a Letter of Representation to the Accountant

Independent Accountant's Report

We have examined management's assertion, included in its representation letter dated February 15, 19XY, that [*identify management's assertion, for example, W Company maintained an effective internal control structure over financial reporting as of December 31, 19XX*].

Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of the internal control structure over financial reporting, testing, and evaluating the design and operating effectiveness of the internal control structure, and such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

Because of inherent limitations in any internal control structure, errors or irregularities may occur and not be detected. Also, projections of any evaluation of the internal control structure over financial reporting to future periods are subject to the risk that the internal control structure may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assertion [*identify management's assertion, for example, that W Company maintained an effective internal control structure over financial reporting as of December 31, 19XX*] is fairly stated, in all material respects, based upon [*identify stated or established criteria*].[1]

This report is intended solely for the information and use of the board of directors and management of W Company [*and, if applicable, a specified regulatory agency*] and should not be used for any other purpose.[2]

[Source: SSAE No. 2, paragraph 54 (AT section 400.54).]

[1] For example, "criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)".

[2] If the report is a matter of public record, the following sentence should be added: "However, this report is a matter of public record and its distribution is not limited."

.030 Modified Report on Management's Assertion About the Effectiveness of an Entity's Internal Control Structure When Management Includes in its Assertion a Description of the Weakness and Its Effect on the Effectiveness of the Entity's Internal Control Structure

Independent Accountant's Report

We have examined management's assertion [*identify management's assertion, for example, that W Company maintained an effective internal control structure over financial reporting as of December 31, 19XX*] included in the accompanying [*title of management report*].

Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of the internal control structure over financial reporting, testing, and evaluating the design and operating effectiveness of the internal control structure, and such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

Because of inherent limitations in any internal control structure, errors or irregularities may occur and not be detected. Also, projections of any evaluation of the internal control structure over financial reporting to future periods are subject to the risk that the internal control structure may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assertion that, except for the effect of the material weakness described in its report, [*identify management's assertion, for example, W Company maintained an effective internal control structure over financial reporting as of December 31, 19XX*] is fairly stated, in all material respects, based upon [*identify established or stated criteria*].[1]

As discussed in management's assertion, the following material weakness exists in the design or operation of the internal control structure of W Company in effect at [*date*]. [*Describe the material weakness and its effect on the achievement of the objectives of the control criteria.*][2] A material weakness is a condition that precludes the entity's internal control structure from providing reasonable assurance that material misstatements in the financial statements will be prevented or detected on a timely basis.

[Source: SSAE No. 2, paragraph 58 (AT section 400.58).]

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[1] For example, "criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)".

[2] The language used by the practitioner ordinarily should conform with management's description of the effect of the material weakness on the effectiveness of the entity's internal control structure.

.040 Adverse Opinion on Management's Assertion About the Effectiveness of an Entity's Internal Control Structure[1]

Independent Accountant's Report

We have examined management's assertion [*identify management's assertion, for example, that W Company maintained an effective internal control structure over financial reporting as of December 31, 19XX*] included in the accompanying [*title of management report*].

Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of the internal control structure over financial reporting, testing, and evaluating the design and operating effectiveness of the internal control structure, and such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

Because of inherent limitations in any internal control structure, errors or irregularities may occur and not be detected. Also, projections of any evaluation of the internal control structure over financial reporting to future periods are subject to the risk that the internal control structure may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Our examination disclosed the following condition, which we believe is a material weakness in the design or operation of the internal control structure of W Company in effect at [*date*]. [*Describe the material weakness and its effect on achievement of the objectives of the control criteria.*] A material weakness is a condition that precludes the entity's internal control structure from providing reasonable assurance that material misstatements in the financial statements will be prevented or detected on a timely basis.

In our opinion, because of the effect of the material weakness described above on the achievement of the objectives of the control criteria, management's assertion [*identify management's assertion, for example, that W Company maintained an effective internal control structure over financial reporting as of December 31, 19XX*] is not fairly stated based upon [*identify established or stated criteria*].[2]

[Source: SSAE No. 2, paragraph 60 (AT section 400.60).]

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[1] This report should be issued if:

a. Management disagrees with the practitioner over the existence of a material weakness and does not include in its assertion a description of the weakness and its effect on the achievement of the objectives of the control criteria, or

b. Management describes the material weakness but does not modify its assertion that the entity's internal control structure is effective.

[2] For example, "criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)".

.050 Qualified Opinion on Management's Assertion About the Effectiveness of an Entity's Internal Control Structure Due to a Scope Limitation

Independent Accountant's Report

We have examined management's assertion [*identify management's assertion, for example, that W Company maintained an effective internal control structure over financial reporting as of December 31, 19XX*] included in the accompanying [*title of management report*].

Except as described below, our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of the internal control structure over financial reporting, testing, and evaluating the design and operating effectiveness of the internal control structure, and such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

Because of inherent limitations in any internal control structure, errors or irregularities may occur and not be detected. Also, projections of any evaluation of the internal control structure over financial reporting to future periods are subject to the risk that the internal control structure may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Our examination disclosed the following material weaknesses in the design or operation of the internal control structure of W Company in effect at [*date*]. A material weakness is a condition that precludes the entity's internal control structure from providing reasonable assurance that material misstatements in the financial statements will be prevented or detected on a timely basis. Prior to December 20, 19XX, W Company had an inadequate system for recording cash receipts, which could have prevented the Company from recording cash receipts on accounts receivable completely and properly. Therefore, cash received could have been diverted for unauthorized use, lost, or otherwise not properly recorded to accounts receivable. Although the Company implemented a new cash receipts system on December 20, 19XX, the system has not been in operation for a sufficient period of time to enable us to obtain sufficient evidence about its operating effectiveness.

In our opinion, except for the effect of matters we may have discovered had we been able to examine evidence about the effectivness of the new cash receipts system, management's assertion [*identify management's assertion, for example, that W Company maintained an effective internal control structure over financial reporting as of December 31, 19XX*] is fairly stated, in all material respects, based upon [*identify established or stated criteria*].[1]

[Source: SSAE No. 2, paragraph 64 (AT section 400.64).]

[1] For example, "criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."

.060 Disclaimer of Opinion on Management's Assertion About the Effectiveness of an Entity's Internal Control Structure Due to a Scope Limitation

Independent Accountant's Report

We were engaged to examine management's assertion [*identify management's assertion, for example, that W Company maintained an effective internal control structure over financial reporting as of December 31, 19XX*] included in the accompanying [*title of management's report*].

[Include paragraph to describe scope restrictions.]

Since management [*describe scope restrictions*] and we were unable to apply other procedures to satisfy ourselves as to management's assertion about the entity's internal control structure over financial reporting, the scope of our work was not sufficent to enable us to express, and we do not express, an opinion on management's assertion.

[Source: SSAE No. 2, paragraph 66 (AT section 400.66).]

.070 Unqualified Opinion on Management's Assertion About the Effectiveness of an Entity's Internal Control Structure Based in Part on the Report of Another Accountant

Independent Accountant's Report

We have examined management's assertion [*identify management's assertion, for example, that W Company maintained an effective internal control structure over financial reporting as of December 31, 19XX*] included in the accompanying [*title of management report*]. We did not examine management's assertion about the effectiveness of the internal control structure over financial reporting of B Company, a wholly owned subsidiary, whose financial statements reflect total assets and revenues constituting 20 and 30 percent, respectively, of the related consolidated financial statement amounts as of and for the year ended December 31, 19XX. Management's assertion about the effectiveness of B Company's internal control structure over financial reporting was examined by other accountants whose report has been furnished to us, and our opinion, insofar as it relates to management's assertion about the effectiveness of B Company's internal control structure over financial reporting, is based solely on the report of the other accountants.

Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of the internal control structure over financial reporting, testing, and evaluating the design and operating effectiveness of the internal control structure, and such other procedures as we considered necessary in the circumstances. We believe that our examination and the report of the other accountants provide a reasonable basis for our opinion.

Because of inherent limitations in any internal control structure, errors or irregularities may occur and not be detected. Also, projections of any evaluation of the internal control structure over financial reporting to future periods are subject to the risk that the internal control structure may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, based on our examination and the report of the other accountants, management's assertion [*identify management's assertion, for example, that W Company maintained an effective internal control structure over financial reporting as of December 31, 19XX*] is fairly stated, in all material respects, based upon [*identify established or stated criteria*].[1]

[Source: SSAE No. 2, paragraph 68 (AT section 400.68).]

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[1] For example, "criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."

.080 Unqualified Opinion on Management's Assertion About the Effectiveness of a Segment of the Entity's Internal Control Structure

Independent Accountant's Report

We have examined management's assertion [*identify management's assertion, for example, that W Company's retail division maintained an effective internal control structure over financial reporting as of December 31, 19XX*], included in the accompanying [*title of management report*].

Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of the internal control structure over financial reporting, testing, and evaluating the design and operating effectiveness of the internal control structure, and such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis of our opinion.

Because of inherent limitations in any internal control structure, errors or irregularities may occur and not be detected. Also, projections of any evaluation of the internal control structure over financial reporting to future periods are subject to the risk that the internal control structure may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assertion [*identify management's assertion, for example, that W Company's retail division maintained an effective internal control structure over financial reporting as of December 31, 19XX*] is fairly stated, in all material respects, based upon [*identify established or stated criteria*].[1]

[Source: SSAE No. 2, paragraph 72 (AT section 400.72).]

[1] For example, "criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."

.090 Unqualified Opinion on Management's Assertion About the Suitability of Design of the Entity's Internal Control Structure

Independent Accountant's Report

We have examined management's assertion [*identify management's assertion, for example, that W Company's internal control structure over financial reporting is suitably designed to prevent or detect material misstatements in the financial statements on a timely basis as of December 31, 19XX*] included in the accompanying [*title of management report*].

Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of the internal control structure over financial reporting, evaluating the design of the internal control structure, and such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

Because of the inherent limitations in any internal control structure, errors or irregularities may occur and not be detected. Also, projections of any evaluation of the internal control structure over financial reporting to future periods are subject to the risk that the internal control structure may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assertion [*identify management's assertion, for example, that W Company's internal control structure over financial reporting is suitably designed to prevent or detect material misstatements in the financial statements on a timely basis as of December 31, 19XX*] is fairly stated, in all material respects, based upon [*identify established or stated criteria*].[1]

[Source: SSAE No. 2, paragraph 74 (AT section 400.74).]

[1] For example, "criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."

.100 Unqualified Opinion on Management's Assertion About the Effectiveness of the Entity's Internal Control Structure Based on Criteria Established by a Regulatory Agency That Did Not Follow Due Process

Independent Accountant's Report

We have examined management's assertion included in its representation letter dated February 15, 19XY, [*identify management's assertion, for example, that W Company's internal control structure over financial reporting as of December 31, 19XX is adequate to meet the criteria established by ________ agency, as set forth in its audit guide dated ________*].

Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of the internal control structure over financial reporting, testing, and evaluating the design and operating effectiveness of the internal control structure, and such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

Because of inherent limitations in any internal control structure, errors or irregularities may occur and not be detected. Also, projections of any evaluation of the internal control structure over financial reporting to future periods are subject to the risk that the internal control structure may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

We understand that the agency considers internal control structure policies and procedures over financial reporting that meet the criteria referred to in the first paragraph of this report adequate for its purpose. In our opinion, based on this understanding and on our examination, management's assertion [*identify management's assertion, for example, that W Company's internal control structure over financial reporting is adequate to meet the criteria esablished by ________ agency*] is fairly stated, in all material respects, based upon such criteria.

This report is intended solely for the information and use of the board of directors and management of W Company [*and, if applicable, a specified regulatory agency*] and should not be used for any other purpose.[1]

[Source: SSAE No. 2, paragraph 77 (AT section 400.77).]

[1] If the report is a matter of public record, the following sentence should be added: "However, this report is a matter of public record and its distribution is not limited."

.110 Communication of Internal Control Structure Matters Noted in an Audit

Independent Auditor's Report

Addressee:

In planning and performing our audit of the financial statements of the ABC Corporation for the year ended December 31, 19XX, we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control structure. However, we noted certain matters involving the internal control structure and its operations that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

[*Include paragraphs to describe the reportable conditions noted.*]

This report is intended solely for the information and use of the audit committee (board of directors, board of trustees, or owners in owner-managed enterprises), managements and others within the organization (or specified regulatory agency or other specified third party).

[*Signature*]

[*Date*]

THE AUDITOR SHOULD NOT ISSUE A REPORT REPRESENTING THAT NO REPORTABLE CONDITIONS WERE NOTED.

[Source: SAS No. 60, paragraphs 12 and 17 (AU section 325.12 and .17).]

.120 Communication of Internal Control Structure Related Matters Noted in an Audit When One or More Reportable Conditions Were Identified, But None is Deemed to be a Material Weakness

Independent Auditor's Report

Addressee:

In planning and performing our audit of the financial statements of the ABC Corporation for the year ended December 31, 19XX, we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control structure. However, we noted certain matters involving the internal control structure and its operations that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

[*Include paragraphs to describe the reportable conditions noted.*]

A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, none of the reportable conditions described above is believed to be a material weakness.

This report is intended solely for the information and use of the audit committee (board of directors, board of trustees, or owners in owner-managed enterprises), managements and others within the organization (or specified regulatory agency or other specified third party).

[*Signature*]

[*Date*]

THE AUDITOR SHOULD NOT ISSUE A REPORT REPRESENTING THAT NO REPORTABLE CONDITIONS WERE NOTED.

[Source: SAS No. 60, paragraphs 12, 16, and 17 (AU section 325.12, .16, and .17).]

.130 Report on Policies and Procedures Placed in Operation at a Service Organization

To XYZ Service Organization:

We have examined the accompanying description of the payroll application of XYZ Service Organization. Our examination included procedures to obtain reasonable assurance about whether (1) the accompanying description presents fairly, in all material respects, the aspects of XYZ Service Organization's policies and procedures that may be relevant to a user organization's internal control structure, (2) the control structure policies and procedures included in the description were suitably designed to achieve the control objectives specified in the description, if those policies and procedures were complied with satisfactorily,[1] and (3) such policies and procedures had been placed in operation as of (*date*). The control objectives were specified by the board of directors. Our examination was performed in accordance with standards established by the American Institute of Certified Public Accountants and included those procedures we considered necessary in the circumstances to obtain a reasonable basis for rendering our opinion.

We did not perform procedures to determine the operating effectiveness of policies and procedures for any period. Accordingly, we express no opinion on the operating effectiveness of any aspects of XYZ Service Organization's policies and procedures, individually or in the aggregate.

In our opinion, the accompanying description of the aforementioned application presents fairly, in all material respects, the relevant aspects of XYZ Service Organization's policies and procedures that had been placed in operation as of (*date*). Also, in our opinion, the policies and procedures, as described, are suitably designed to provide reasonable assurance that the specified control objectives would be achieved if the described policies and procedures were complied with satisfactorily.

The description of policies and procedures at XYZ Service Organization is as of (*date*) and any projection of such information to the future is subject to the risk that, because of change, the description may no longer portray the system in existence. The potential effectiveness of specific policies and procedures at the Service Organization is subject to inherent limitations and, accordingly, errors or irregularities may occur and not be detected. Furthermore, the projection of any conclusions, based on our findings, to future periods is subject to the risk that changes may alter the validity of such conclusions.

This report is intended solely for use by the management of XYZ Service Organization, its customers, and the independent auditors of its customers.

[Source: SAS No. 70, paragraph 38 (AU section 324.38), effective for service auditors' reports dated after March 31, 1993, with earlier application encouraged.]

[1] If the application of internal control structure policies and procedures by user organizations is necessary to achieve the stated control objectives, the service auditor's report should be modified to include the phrase "and user organizations applied the internal control structure policies and procedures contemplated in the design of XYZ Service Organization's policies and procedures" following the words "complied with satisfactorily" in the scope and opinion paragraphs.

.140 Report on Policies and Procedures Placed in Operation at a Service Organization and Tests of Operating Effectiveness

To XYZ Service Organization:

We have examined the accompanying description of the payroll application of XYZ Service Organization. Our examination included procedures to obtain reasonable assurance about whether (1) the accompanying description presents fairly, in all material respects, the aspects of XYZ Service Organization's policies and procedures that may be relevant to a user organization's internal control structure, (2) the control structure policies and procedures included in the description were suitably designed to achieve the control objectives specified in the description, if those policies and procedures were complied with satisfactorily,[1] and (3) such policies and procedures had been placed in operation as of *(date)*. The control objectives were specified by the board of directors. Our examination was performed in accordance with standards established by the American Institute of Certified Public Accountants and included those procedures we considered necessary in the circumstances to obtain a reasonable basis for rendering our opinion.

In our opinion, the accompanying description of the aforementioned application presents fairly, in all material respects, the revelant aspects of XYZ Service Organization's policies and procedures that had been placed in operation as of *(date)*. Also, in our opinion, the policies and procedures, as described, are suitably designed to provide reasonable assurance that the specified control objectives would be achieved if the described policies and procedures were complied with satisfactorily.

In addition to the procedures we considered necessary to render our opinion as expressed in the previous paragraph, we applied tests to specific policies and procedures, listed in Schedule X, to obtain evidence about their effectiveness in meeting the control objectives, described in Schedule X, during the period from *(date)* to *(date)*. The specific policies and procedures and the nature, timing, extent, and results of the tests are listed in Schedule X. This information has been provided to user organizations of XYZ Service Organization and to their auditors to be taken into consideration, along with information about the internal control structure at user organizations, when making assessments of control risk for user organizations. In our opinion the policies and procedures that were tested, as described in Schedule X, were operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the control objectives specified in Schedule X were achieved during the period from *(date)* to *(date)*. [However, the scope of our engagement did not include tests to determine whether control objectives not listed in Schedule X were achieved; accordingly, we express no opinion on the achievement of control objectives not included in Schedule X.] [2]

The relative effectiveness and significance of specific policies and procedures at XYZ Service Organization and their effect on assessments of control risk at user organizations are dependent on their interaction with the policies, procedures, and other factors present at individual user organizations. We have performed no procedures to evaluate the effectiveness of policies and procedures at individual user organizations.

The description of policies and procedures at XYZ Service Organization is as of *(date)*, and information about tests of the operating effectiveness of specified policies and procedures covers the period from *(date)* to *(date)*. Any projection of such information to the future is subject to the risk that, because of change, the description may no longer portray the system in existence. The potential effectiveness of specified policies and procedures at the Service Organization is subject to inherent limitations and, accordingly, errors or irregularities may occur and not

[1] If the application of internal control structure policies and procedures by user organizations is necessary to achieve the stated control objectives, the service auditor's report should be modified to include the phrase "and user organizations applied the internal control structure policies and procedures contemplated in the design of XYZ Service Organization's policies and procedures" following the words "complied with satisfactorily" in the scope and opinion paragraphs.

[2] This sentence should be added when all of the control objectives listed in the description of policies and procedures placed in operation are not covered by the tests of operating effectiveness. This sentence would be omitted when all of the control objectives listed in the description of policies and procedures placed in operation are included in the tests of operating effectiveness.

be detected. Furthermore, the projection of any conclusions, based on our findings, to future periods is subject to the risk that changes may alter the validity of such conclusions.

This report is intended solely for use by the management of XYZ Service Organization, its customers, and the independent auditors of its customers.

[Source: SAS No. 70, paragraph 54 (AU section 324.54), effective for service auditors' reports dated after March 31, 1993, with earlier application encouraged.]

.150 Reports on Internal Control Required by SEC Rule 17a-5

Board of Directors
Standard Stockbrokerage Co., Inc.

In planning and performing our audit of the consolidated financial statements of Standard Stockbrokerage Co., Inc. for the year ended December 31, 19X1, we considered its internal control structure, including procedures for safeguarding securities, in order to determine our auditing procedures for the purpose of expressing our opinion on the consolidated financial statements and not to provide assurance on the internal control structure.

Also, as required by rule 17a-5(g)(1) of the Securities and Exchange Commission, we have made a study of the practices and procedures (including tests of compliance with such practices and procedures) followed by Standard Stockbrokerage Co., Inc. that we considered relevant to the objectives stated in rule 17a-5(g), (1) in making the periodic computations of aggregate indebtedness (or aggregate debits) and net capital under rule 17a-3(a)(11) and the reserve required by rule 15c3-3(e); (2) in making the quarterly securities examinations, counts, verifications and comparisons, and the recordation of differences required by rule 17a-13; (3) in complying with the requirements for prompt payment for securities under section 8 of Regulation T of the Board of Governors of the Federal Reserve System; and (4) in obtaining and maintaining physical possession or control of all fully paid and excess margin securities of customers as required by rule 15c3-3.

The management of the Company is responsible for establishing and maintaining an internal control structure and the practices and procedures referred to in the preceding paragraph. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures and of the practices and procedures referred to in the preceding paragraph and to assess whether those practices and procedures can be expected to achieve the Commission's above-mentioned objectives. Two of the objectives of an internal control structure and the practices and procedures are to provide management with reasonable, but not absolute, assurance that assets for which the Company has responsibility are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and recorded properly to permit preparation of financial statements in conformity with generally accepted accounting principles. Rule 17a-5(g) lists additional objectives of the practices and procedures listed in the preceding paragraph.

Because of inherent limitations in any internal control structure or the practices and procedures referred to above, errors or irregularities may occur and not be detected. Also, projection of any evaluation of them to future periods is subject to the risk that they may become inadequate because of changes in conditions or that the effectiveness of their design and operation may deteriorate.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. However, we noted no matters involving the internal control structure, including procedures for safeguarding securities, that we consider to be material weaknesses as defined above.[1]

[1] If conditions believed to be material weaknesses are disclosed, the report should describe the weaknesses that have come to the auditor's attention and may state that these weaknesses do not affect the report on the financial statements. The last sentence of the fifth paragraph of the report should be modified as follows:

> However, we noted the following matters involving the [control environment, accounting system, control procedures, or procedures for safeguarding securities] and its [their] operation that we consider to be material weaknesses as defined above. These conditions were considered in determining the nature, timing, and extent of the procedures to be performed in our audit of the consolidated financial statements of Standard Stockbrokerage Co., Inc. for the year ended December 31, 19X1, and this report does not affect our report thereon dated February

We understand that practices and procedures that accomplish the objectives referred to in the second paragraph of this report are considered by the Commission to be adequate for its purposes in accordance with the Securities Exchange Act of 1934 and related regulations, and that practices and procedures that do not accomplish such objectives in all material respects indicate a material inadequacy for such purposes. Based on this understanding and on our study, we believe that the Company's practices and procedures were adequate at December 31, 19X1, to meet the Commission's objectives.[2]

This report is intended solely for the use of management, the Securities and Exchange Commission, the New York Stock Exchange and other regulatory agencies which rely on Rule 17a-5(g) under the Securities Exchange Act of 1934 and should not be used for any other purpose.

Accounting Firm
New York, New York
February 15, 19X2

[Source: SOP 89-4, *Reports on the Internal Control Structure in Audits of Brokers and Dealers in Securities.*]

NOTE:

The issuance of Statement on Standards for Attestation Engagements No. 2, *Reporting on an Entity's Internal Control Structure Over Financial Reporting* (AT section 400), has not changed the reporting requirements under the Securities Exchange Act of 1934. This report would still be issued under Rule 17a-5.

(Footnote Continued)

15, 19X2. [A description of the material weaknesses that have come to the auditor's attention and corrective action would follow.]

[2] Whenever inadequacies are described, the report should include the last sentence of the fifth paragraph as modified in the note above. The report should also describe material inadequacies that the auditor becomes aware of that existed during the period but were corrected prior to the end of the period unless management already has reported them to the SEC.

.160 Report on Internal Control Required by SEC Rule 17a-5 When Broker or Dealer Has Not Made the Required Notification or When the Auditor Does Not Agree With the Statements Therein

December 10, 19X1

Securities and Exchange Commission

Washington D.C. and Appropriate

Regional Office

Designated Examining Authority

Dear Sirs:

Our most recent audit of the consolidated financial statements of Standard Stockbrokerage Co., Inc. and Subsidiaries was as of December 31, 19X0, and for the year then ended, which we reported on under date of February 15, 19X1. We have not audited any financial statements of the Company as of any date or for any period subsequent to December 31, 19X0. Although we are presently performing certain procedures as part of our audit of the consolidated financial statements of the Company as of December 31, 19X1, and for the year then ended, these procedures do not constitute all the procedures necessary in an audit conducted in accordance with generally accepted auditing standards or all the procedures necessary to (1) consider the Company's internal control structure as required by generally accepted auditing standards or (2) study the Company's practices and procedures relevant to the objectives stated in rule 17a-5(g) of the Securities and Exchange Commission as required by rule 17a-5.

The management of Standard Stockbrokerage Co., Inc. is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles.

Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the internal control structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

The purpose of performing certain procedures prior to the date of the financial statements is to facilitate the expression of an opinion on the Company's financial statements. It must be understood that the procedures performed would not necessarily disclose all material weaknesses in the internal control structure, including procedures for safeguarding securities.

However, pursuant to the requirements of rule 17a-5(h)(2), we are to call to the attention of the chief financial officer any weaknesses that we believe to be material and that were disclosed during the course of interim work. We have made such notification to the chief financial officer of Standard Stockbrokerage Co., Inc. and we believe the following additional information is required pursuant to the requirements of rule 17a-11(f).

[*List and describe all instances where the independent auditor did not agree with the notification of the broker or dealer or where the required notification was not made.*]

Accounting Firm

New York, New York

[Source: SOP 89-4, *Reports on the Internal Control Structure in Audits of Brokers and Dealers in Securities.*]

NOTE:

The issuance of Statement on Standards for Attestation Engagements No. 2, *Reporting on an Entity's Internal Control Structure Over Financial Reporting* (AT section 400), has not changed the reporting requirements under the Securities Exchange Act of 1934. This report would still be issued under Rule 17a-5.

[The next page is 10,521.]

AAM Section 10,260
Special Reports

.010 Cash Basis Statements

Independent Auditor's Report

Addressee:

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

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

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the assets and liabilities arising from cash transactions of XYZ Company as of December 31, 19X2 and 19X1, and its revenue collected and expenses paid during the years then ended, on the basis of accounting described in Note X.

[*Signature*]

[*Date*]

[Source: SAS No. 62, paragraph 8 (AU section 623.08).]

.020 Income Tax Basis Statements

Independent Auditor's Report

Addressee:

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

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

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

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

[*Signature*]

[*Date*]

[Source: SAS No. 62, paragraph 8 (AU section 623.08).]

.030 Regulatory (Statutory) Basis Statements

Independent Auditor's Report

Addressee:

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

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.

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

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

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

[*Signature*]

[*Date*]

[Source: SAS No. 62, paragraph 8 (AU section 623.08).]

.040 Report Relating to Amount of Sales for the Purpose of Computing Rental

Independent Auditor's Report

Addressee:

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

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

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

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

[*Signature*]

[*Date*]

[Source: SAS No. 62, paragraph 18 (AU section 623.18).]

.050 Royalties

Independent Auditor's Report

Addressee:

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

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

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

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

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

[*Signature*]

[*Date*]

[Source: SAS No. 62, paragraph 18 (AU section 623.18).]

.060 Profit Participation[1]

Independent Auditor's Report

Addressee:

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

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

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

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

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

[*Signature*]

[*Date*]

[Source: SAS No. 62, paragraph 18 (AU section 623.18).]

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[1] A report on an examination of a schedule of profit participation should be issued only if the auditor has examined the financial statements on which the participation is based.

.070 Report on Federal and State Income Taxes in Financial Statements

Independent Auditor's Report

Addressee:

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

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

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

[*Signature*]

[*Date*]

[Source: SAS No. 62., paragraph 18 (AU section 623.18).]

.080 Proposed Acquisition

Board of Directors

X Company

We have applied certain agreed-upon procedures, as discussed below, to accounting records of Y Company, Inc., as of December 31, 19XX, solely to assist you in connection with the proposed acquisition of Y Company, Inc. It is understood that this report is solely for your information and is not to be referred to or distributed for any purpose to anyone who is not a member of management of X Company. Our procedures and findings are as follows:

a. We reconciled cash on deposit with the following banks to the balances in the respective general ledger accounts and obtained confirmation of the related balances from the banks.

Bank	*Balance Per General Ledger*
ABC National Bank	$5,000
DEF State Bank	13,776
XYZ Trust Company—regular account	86,912
XYZ Trust Company—payroll account	5,000

b. We obtained an aged trial balance of the accounts receivable subsidiary records, traced the age and amounts of approximately 10 percent of the accounts to the accounts receivable ledger, and added the trial balance and compared the total with the balance in the general ledger control account. We mailed requests for positive confirmation of balances to 150 customers. The differences disclosed in confirmation replies were minor in amount and nature, and we reconciled them to our satisfaction. The results are summarized as follows:

	Accounts Receivable Aging and Confirmation		
		Confirmation Results	
	Account Balance	*Requested*	*Received*
Current	$156,000	$ 76,000	$ 65,000
Past due:			
Less than one month	60,000	30,000	19,000
One to three months	36,000	18,000	10,000
Over three months	48,000	48,000	8,000
	$300,000	$172,000	$102,000

Because the above procedures do not constitute an audit conducted in accordance with generally accepted auditing standards, we do not express an opinion on any of the accounts or items referred to above. In connection with the procedures referred to above, no matters came to our attention that caused us to believe that the specified accounts or items should be adjusted. Had we performed additional procedures or had we audited the financial statements in accordance with generally accepted auditing standards, matters might have come to our attention that would have been reported to you. This report relates only to the accounts and items specified above and does not extend to any financial statements of Y Company, Inc., taken as a whole.

[*Signature*]

[*Date*]

[Source: SAS No. 35, paragraph 6 (AU section 622.06).]

.090 Claims of Creditors

Trustee
XYZ Company

At your request, we have performed the procedures enumerated below with respect to the claims of creditors of XYZ Company as of May 31, 19XX, set forth in the accompanying schedules. Our review was made solely to assist you in evaluating the reasonableness of those claims, and our report is not to be used for any other purpose. The procedures we performed are summarized as follows:

a. We compared the total of the trial balance of accounts payable at May 31, 19XX, prepared by the company, to the balance in the company's related general ledger account.

b. We compared the claims received from creditors to the trial balance of accounts payable.

c. We examined documentation submitted by the creditors in support of their claims and compared it to documentation in the company's files, including invoices, receiving records, and other evidence of receipt of goods or services.

Our findings are presented in the accompanying schedules. Schedule A lists claims that are in agreement with the company's records. Schedule B lists claims that are not in agreement with the company's records and sets forth the differences in amounts.

Because the above procedures do not constitute an audit conducted in accordance with generally accepted auditing standards, we do not express an opinion on the accounts payable balance as of May 31, 19XX. In connection with the procedures referred to above, except as set forth in Schedule B, no matters came to our attention that caused us to believe that the accounts payable balance might require adjustment. Had we performed additional procedures or had we audited the financial statements in accordance with generally accepted auditing standards, other matters might have come to our attention that would have been reported to you. This report relates only to the accounts and items specified above and does not extend to any financial statements of XYZ Company, taken as a whole.

[*Signature*]

[*Date*]

[Source: SAS No. 35, paragraph 6 (AU section 622.06).]

.100 Compliance With Contractual Provisions (Separate Report)

We have examined the balance sheet of XYZ Company as of December 31, 19X1, and the related statements of income, retained earnings, and changes in financial position for the year then ended, and have issued our report thereon dated February 16, 19X2. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In connection with our examination, nothing came to our attention that caused us to believe that the Company was not in compliance with any of the terms, covenants, provisions, or conditions of sections XX to XX, inclusive, of the Indenture dated July 21, 19X0, with ABC Bank. However, it should be noted that our examination was not directed primarily toward obtaining knowledge of such noncompliance.

[Source: SAS No. 14, paragraph 19 (AU section 621.19).]

.110 Report on Compliance With Contractual Provisions Included in Auditor's Standard Report Accompanying Financial Statements

Independent Auditor's Report

Addressee:

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

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 as of December 31, 19XX, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

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

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

[*Signature*]

[*Date*]

[Source: SAS No. 62, paragraph 21 (AU section 623.21).]

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

Independent Auditor's Report

Addressee:

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

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

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

[*Signature*]

[*Date*]

[Source: SAS No. 62, paragraph 21 (AU section 623.21).]

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

Independent Auditor's Report

Addressee:

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

We conducted our audit in accordance with 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 to our opinion.

The accompanying special-purpose financial statements were prepared for the purpose of complying with, and on the basis of accounting practices specified in, section 4 of a loan agreement between DEF Bank and the Company dated (*date*), as described in Note X, and are not intended to be a presentation in conformity with generally accepted accounting principles.

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

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

[*Signature*]

[*Date*]

[Source: SAS No. 62, paragraph 30 (AU section 623.30).]

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

Independent Auditor's Report

Addressee:

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

We conducted our audit in accordance with 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 to our opinion.

The accompanying special-purpose financial statements were prepared for the purpose of complying with, and on the basis of accounting practices specified in, an acquisition agreement dated May 15, 19XX, between ABC Company and DEF Company, as discussed in Note X, and are not intended to be a presentation in conformity with generally accepted accounting principles.

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

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

[*Signature*]

[*Date*]

[Source: SAS No. 62, paragraph 30 (AU section 623.30).]

.140 Report on a Schedule of Gross Income and Certain Expenses to Meet Regulatory Requirements and to be Included in a Document Distributed to the General Public

Independent Auditor's Report

Addressee:

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

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

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

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

[*Signature*]

[*Date*]

[Source: SAS No. 62, paragraph 26 (AU section 623.26).]

.141 Report on a Statement of Assets Sold and Liabilities Transferred to Comply With a Contractual Agreement

Independent Auditor's Report

Addressee:

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

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 statement of net assets sold is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the statement. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the statement of net assets sold. We believe that our audit provides a reasonable basis for our opinion.

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

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

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

[*Signature*]

[*Date*]

[Source: SAS No. 62, paragraph 26 (AU section 623.26).]

.150 Report on the Application of Accounting Principles

Introduction

We have been engaged to report on the appropriate application of generally accepted accounting principles to the specific (hypothetical) transaction described below. This report is being issued to the ABC Company (XYZ Intermediaries) for assistance in evaluating accounting principles for the described specific (hypothetical) transaction. Our engagement has been conducted in accordance with standards established by the American Institute of Certified Public Accountants.

Description of Transaction

The facts, circumstances, and assumptions relevant to the specific (hypothetical) transaction as provided to us by the management of ABC Company (XYZ Intermediaries) are as follows:

> Prior to 19X1, ABC Company used the accelerated cost recovery method (ACRS) to depreciate fixed assets for financial reporting and income tax purposes. The number of years specified by ACRS for recovery deductions of the fixed assets did not fall within a reasonable range of the asset's useful life. ABC Company switched to the straight-line method of depreciating its fixed assets in the current year.

Appropriate Accounting Principles

The change in depreciation methods should be accounted for as a prior period adjustment in the current year's financial statements in accordance with FASB Statement No. 16, *Prior Period Adjustments,* paragraph 11 [AC A35.103]. Since the number of years specified by ACRS for recovery deductions of the fixed assets did not fall within a reasonable range of the asset's useful life, the ACRS method would not be considered a generally accepted accounting principle. According to APB Opinion 20, *Accounting Changes,* paragraph 13 [AC A35.104], "A change from an accounting principle that is not generally accepted to one that is generally accepted is a correction of an error for purposes of applying this Opinion."

Concluding Comments

The ultimate responsibility for the decision on the appropriate applications of generally accepted accounting principles for an actual transaction rests with the preparers of financial statements, who should consult with their continuing accountants. Our judgment on the appropriate application of generally accepted accounting principles for the described specific (hypothetical) transaction is based solely on the facts provided to us as described above; should these facts and circumstances differ, our conclusion may change.

[Source: SAS No. 50, paragraph 9 (AU section 625.09).]

.160 Report on Financial Statements Presented in Conformity With a Prescribed Basis of Accounting (Property and Liability Insurance Company)

Independent Auditor's Report

Addressee:

We have audited the accompanying statutory-basis balance sheets of P and C Insurance Company as of December 31, 19X2 and 19X1, and the related statutory-basis statements of income, surplus, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to report on these financial statements based on our audits.

We conducted our audits of the accompanying statutory-basis financial statements in accordance with generally accepted auditing standards; however, as discussed in the following paragraph, we were not engaged to determine or audit the effects of the variances between statutory accounting practices and generally accepted accounting principles. Generally accepted auditing 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 on the accompanying statutory-basis financial statements.

The Company presents its financial statements in conformity with accounting practices prescribed or permitted by the [*name of state*] Insurance Department. When statutory-basis financial statements are presented for purposes other than for filing with a regulatory agency, generally accepted auditing standards require that an auditor's report on them state whether they are presented in conformity with generally accepted accounting principles. The accounting practices used by the Company vary from generally accepted accounting principles as explained in Note X, and the Company has not determined the effects of these variances. Accordingly, we were not engaged to audit, and we did not audit, the effects of these variances. Since the financial statements referred to above do not purport to be a presentation in conformity with generally accepted accounting principles, we are not in a position to express and do not express an opinion on the financial statements referred to above as to fair presentation of financial position, results of operations, or cash flows in conformity with generally accepted accounting principles.

In our opinion, the statutory-basis financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and shareholders' (members') equity of P and C Insurance Company at December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting practices prescribed or permitted by the [*name of state*] Insurance Department.

[*Signature*]

[*Date*]

[Source: SOP 90-10, *Reports on Audited Financial Statements of Property and Liability Insurance Companies.*]

[The next page is 10,571.]

AAM Section 10,270
Unaudited Financial Statements of a Public Entity

.01 Disclaimer

Addressee:

The accompanying balance sheet of X Company as of December 31, 19X1, and the related statements of income, retained earnings, and cash flows for the year then ended were not audited by us, and, accordingly, we do not express an opinion on them.

[*Signature*]

[*Date*]

[Source: SAS No. 26, paragraph 5 (AU section 504.05).]

NOTES:

- The disclaimer may accompany the unaudited financial statements or it may be placed directly on them. In addition, each page of the financial statements should be clearly and conspicuously marked as unaudited.
- If the unaudited financial statements are those of a privately held (nonpublic) company, this example is not appropriate. See AAM sections 10,400 and 10,500.

.02 Current Period Financial Statements Unaudited—Prior Period Financial Statements Audited

Addressee:

The accompanying balance sheet of ABC Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended were not audited by us and, accordingly, we do not express an opinion on them.

The financial statements for the year ended December 31, 19X1, were audited by us (other accountants) and we (they) expressed an unqualified opinion on them in our (their) report dated March 1, 19X2, but we (they) have not performed any auditing procedures since that date.

[*Signature*]

[*Date*]

[Source: SAS No. 26, paragraphs 5 and 16 (AU section 504.05 and .16).]

NOTES:

- The disclaimer may accompany the unaudited financial statements or it may be placed directly on them. In addition, each page of the financial statements should be clearly and conspicuously marked as unaudited.
- If the unaudited financial statements are those of a privately held (nonpublic) company, this example is not appropriate. See AAM sections 10,400 and 10,500.

.03 Disclaimer—Cash Basis Statements

Addressee:

The accompanying statement of assets and liabilities resulting from cash transactions of XYZ Corporation as of December 31, 19X1, and the related statement of revenues collected and expenses paid during the year then ended were not audited by us and, accordingly, we do not express an opinion on them.

[*Signature*]

[*Date*]

[Source: SAS No. 26, paragraph 7 (AU section 504.07).]

NOTES:

- A note to the financial statements should describe how the basis of presentation differs from generally accepted accounting principles, but the monetary effect of such differences need not be stated.
- The disclaimer may accompany the unaudited financial statements or it may be placed directly on them. In addition, each page of the financial statements should be clearly and conspicuously marked as unaudited.

.04 Disclaimer—Regulatory (Statutory) Basis Statements

Addressee:

The accompanying statement of admitted assets, liabilities, and surplus (statutory basis) of XYZ Insurance Company as of December 31, 19XX, and the related statements of income (statutory basis) and changes in surplus (statutory basis) for the year then ended were not audited by us and, accordingly, we do not express an opinion on them.

[*Signature*]

[*Date*]

[Source: SAS No. 26, paragraph 7 (AU section 504.07).]

NOTES:

- A note to the financial statements should describe how the basis of presentation differs from generally accepted accounting principles, but the monetary effect of such differences need not be stated.
- The disclaimer may accompany the unaudited financial statements or it may be placed directly on them. In addition, each page of the financial statements should be clearly and conspicuously marked as unaudited.

[The next page is 10,621.]

AAM Section 10,280
Lack of Independence

.01 Disclaimer

Addressee:

We are not independent with respect to XYZ Company, and the accompanying balance sheet as of December 31, 19X1, and the related statements of income, retained earnings, and cash flows for the year then ended were not audited by us and, accordingly, we do not express an opinion on them.

[*Signature*]

[*Date*]

[Source: SAS No. 26, paragraph 10 (AU section 504.10).]

NOTE:

- When an accountant is not independent, any procedures he might perform would not be in accordance with generally accepted auditing standards and he would be precluded from expressing an opinion on the financial statements. Accordingly, he would disclaim an opinion with respect to the financial statements and state specifically that he is not independent. The accountant should not include in his disclaimer the reasons for the lack of independence or any description of the procedures he has performed; including such matters might confuse readers concerning the importance of the lack of independence.

[The next page is 10,671.]

AAM Section 10,300
Review of Interim Financial Information

.01 Independent Accountant's Report

Independent Accountant's Report

Addressee:

We have reviewed the accompanying [*describe the statements or information reviewed*] of ABC Company and consolidated subsidiaries as of September 30, 19X1, and for the three-month and nine-month periods then ended. These financial statements (information) are (is) the responsibility of the company's management.

We conducted our review in accordance with standards established by the American Institute of Certified Public Accountants. A review of interim financial information consists principally of applying analytical procedures to financial data and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

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

[*Signature*]

[*Date*]

[Source: SAS No. 71, paragraph 28 (AU section 722.28), effective for interim periods within fiscal years beginning after September 15, 1992. Reports issued or reissued after September 15, 1992 (including engagements based on procedures under SAS No. 36), should conform with the reporting guidance in SAS No. 71. Earlier application is encouraged.]

NOTE:

SAS No. 71, *Interim Financial Information* (AU section 722), provides guidance for accountants engaged to review interim financial information of a public entity. SAS No. 71 (AU section 722) may also, in certain limited situations, apply to reviews of interim financial information for nonpublic entities. The accountant should refer to the SAS to determine its applicability.

[The next page is 10,721.]

AAM Section 10,400

Accountant's Report on Compilation of Financial Statements of a Nonpublic Entity

.01 Accountant's Standard Report

Addressee:

I (We) have compiled the accompanying balance sheet of XYZ Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

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

[*Signature*]

[*Date*]

[Source: SSARS 1, paragraph 17, as amended by SSARS 7 (AR section 100.17).]

NOTE:

Statements on Standards for Accounting and Review Services provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity, or a public entity as noted in SSARS 7.

.02 Omission of Substantially All Disclosures

Addressee:

I (We) have compiled the accompanying balance sheet of XYZ Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

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

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 the cash flows. Accordingly, these financial statements are not designed for those who are not informed about such matters.

[*Signature*]

[*Date*]

[Source: SSARS 1, paragraph 21, as amended by SSARS 7 (AR section 100.21).]

NOTES:

Statements on Standards for Accounting and Review Services provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity, or a public entity as noted in SSARS 7.

This form of report is appropriate only for a compilation engagement, not for a review engagement.

.03 Omission of Statement of Cash Flows and Substantially All Disclosures

Addressee:

I (We) have compiled the accompanying balance sheet of XYZ Company as of December 31, 19XX, 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 (owners). I (We) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

Management has elected to omit substantially all of the disclosures and the statement of cash flows required by generally accepted accounting principles. If the omitted disclosures and the statement of cash flows 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.

[*Signature*]

[*Date*]

[Source: SSARS 1, paragraph 21, as amended by SSARS 7 (AR section 100.21).]

NOTES:

Statements on Standards for Accounting and Review Services provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity, or a public entity as noted in SSARS 7.

This form of report is appropriate only for a compilation engagement, not for a review engagement.

.04 Accountant Not Independent

Addressee:

I (We) have compiled the accompanying balance sheet of XYZ Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

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

I am (We are) not independent with respect to XYZ Company.[1]

[*Signature*]

[*Date*]

[Sources: SSARS 1, paragraph 17, as amended by SSARS 7 (AR section 100.17) and SSARS 1, paragraph 22 (AR section 100.22).]

NOTE:

Statements on Standards for Accounting and Review Services provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity, or a public entity as noted in SSARS 7.

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[1] In making a judgment about whether he is independent, the accountant should be guided by the AICPA Code of Professional Conduct. For example, the accountant should be aware that interpretation 101-3 (ET section 101.05) under rule 101 (ET section 101.01) of the rules of conduct indicates that independence is not necessarily impaired when an accountant provides manual or automated bookkeeping or data processing services to a client.

.05 Departure From GAAP—Omission of Statement of Cash Flows

Addressee:

I (We) have compiled the accompanying balance sheet of XYZ Company as of December 31, 19XX, 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 (owners). I (We) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them. However, I (we) did become aware of a departure from generally accepted accounting principles that is described in the following paragraph.

A statement of cash flows for the year ended December 31, 19XX, 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.

[*Signature*]

[*Date*]

[Source: SSARS 1, paragraph 40, as amended by SSARS 7 (AR section 100.40).]

NOTE:

Statements on Standards for Accounting and Review Services provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity, or a public entity as noted in SSARS 7.

.06 Departure From GAAP—Accounting Principles Not Generally Accepted

Addressee:

I (We) have compiled the accompanying balance sheet of XYZ Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of financial statements information that is the representation of management (owners). I (We) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them. However, I (we) did become aware of a departure (certain departures) from generally accepted accounting principles that is (are) described in the following paragraph(s).

As disclosed in note X to the financial statements, generally accepted accounting principles require that land be stated at cost. Management has informed me (us) that the company has stated its land at appraised value and that, if generally accepted accounting principles had been followed, the land account and stockholders' equity would have been decreased by $500,000.

[*Signature*]

[*Date*]

[Source: SSARS 1, paragraph 40, as amended by SSARS 7 (AR section 100.40).]

NOTE:

Statements on Standards for Accounting and Review Services provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity, or a public entity as noted by SSARS 7.

.07 Cash Basis Statements*—Full Disclosure

Addressee:

I (We) have compiled the accompanying statement of assets and liabilities arising from cash transactions of XYZ Company as of December 31, 19XX, and the related statement of revenue collected and expenses paid 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.

[*Signature*]

[*Date*]

[Source: Accounting and Review Services Interpretation No. 12 of SSARS 1, as amended by SSARS 7 (AR section 9100.45).]

NOTE:

Statements on Standards for Accounting and Review Services provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity, or a public entity as noted in SSARS 7.

* When financial statements are prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles, the notes ordinarily would state the basis of presentation and describe how that basis differs from generally accepted accounting principles. [Source: Accounting and Review Services Interpretation No. 12 of SSARS No. 1 (AR section 9100.45).]

.08 Cash Basis Statements—Omission of Substantially All Disclosures, With No Reference to Basis

Addressee:

I (We) have compiled the accompanying statement of assets and liabilities arising from cash transactions of XYZ Company as of December 31, 19XX, and the related statement of revenue collected and expenses paid for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The financial statements have been prepared on the cash basis of accounting, which is a comprehensive basis of accounting other than generally accepted accounting principles.

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

Management has elected to omit substantially all of the informative disclosures ordinarily included in financial statements prepared on the cash basis of accounting. If the omitted disclosures were included in the financial statements, they might influence the user's conclusions about the Company's assets, liabilities, equity, revenue and expenses. Accordingly, these financial statements are not designed for those who are not informed about such matters.

[*Signature*]

[*Date*]

[Source: Accounting and Review Services Interpretation No. 12 of SSARS 1, as amended by SSARS 7 (AR section 9100.45).]

NOTE:

Statements on Standards for Accounting and Review Services provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity, or a public entity as noted in SSARS 7.

.09 Income Tax Basis Statements—Full Disclosure

Addressee:

I (We) have compiled the accompanying statement of assets, liabilities, and capital—income tax basis of ABC Partnership as of December 31, 19XX, and the related statements of revenue and expenses—income tax basis and of changes in partners' capital accounts—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.

[*Signature*]

[*Date*]

[Source: Accounting and Review Services Interpretation No. 12 of SSARS 1, as amended by SSARS 7 (AR section 9100.45).]

NOTES:

Statements on Standards for Accounting and Review Services provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity, or a public entity as noted in SSARS 7.

When financial statements are prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles, the notes ordinarily would state the basis of presentation and describe how that basis differs from generally accepted accounting principles.

.10 Income Tax Basis Statements—Omission of Substantially All Disclosures, With No Reference to Basis

Addressee:

I (We) have compiled the accompanying statement of assets, liabilities, and equity—income tax basis of XYZ Company as of December 31, 19XX, and the related statement of revenue and expenses—income tax basis for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The financial statements have been prepared on the accounting basis used by the Company for Federal income tax purposes, which is a comprehensive basis of accounting other than generally accepted accounting principles.

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

Management has elected to omit substantially all of the disclosures ordinarily included in financial statements prepared on the income tax basis of accounting. If the omitted disclosures were included in the financial statements, they might influence the user's conclusions about the Company's assets, liabilities, equity, revenue and expenses. Accordingly, these financial statements are not designed for those who are not informed about such matters.

[*Signature*]

[*Date*]

[Source: Accounting and Review Services Interpretation No. 12 of SSARS 1, as amended by SSARS 7 (AR section 9100.45).]

NOTE:

Statements on Standards for Accounting and Review Services provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity, or a public entity as noted in SSARS 7.

.11 Continuing Accountant's Report on Comparative Statements—Both Periods Compiled

Addressee:

I (We) have compiled the accompanying balance sheets of XYZ Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

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

[*Signature*]

[*Date*]

[Source: SSARS 2, paragraph 9, as amended by SSARS 7 (AR section 200.09).]

NOTE:

Statements on Standards for Accounting and Review Services provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity, or a public entity as noted in SSARS 7.

.12 Continuing Accountant's Report on Comparative Statements—Current Period Compiled With Reference to Review Report on Prior-Period

Addressee:

I (We) have compiled the accompanying balance sheet of XYZ Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended, 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 19X2 financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

The accompanying 19X1 financial statements of XYZ Company were previously reviewed by me (us) and my (our) report dated March 1, 19X2, stated that I was (we were) not aware of any material modifications that should be made to those statements in order for them to be in conformity with generally accepted accounting principles. I (We) have not performed any procedures in connection with that review engagement after the date of my (our) report on the 19X1 financial statements.

[*Signature*]

[*Date*]

[Sources: SSARS 2, paragraph 12 (AR section 200.12) and SSARS 1, paragraph 17, as amended by SSARS 7 (AR section 100.17).]

NOTE:

Statements on Standards for Accounting and Review Services provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity, or a public entity as noted in SSARS 7.

.13 Continuing Accountant's Report on Comparative Statements—Both Periods Compiled With Restatement of Prior-Period Financial Statements[1]

Addressee:

I (We) have compiled the accompanying balance sheets of XYZ Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

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

In my (our) previous compilation report dated March 1, 19X2, on the 19X1 financial statements, I (we) referred to a departure from generally accepted accounting principles because the company carried its land at appraised values. However, as disclosed in Note X, the company has restated its 19X1 financial statements to reflect its land at cost in accordance with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Sources: SSARS 2, paragraph 15 (AR section 200.15) and SSARS 1, paragraph 17, as amended by SSARS 7 (AR section 100.17).]

NOTE:

Statements on Standards for Accounting and Review Services provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity, or a public entity as noted in SSARS 7.

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[1] A changed reference to a departure from generally accepted accounting principles includes the removal of a prior reference or the inclusion of a new reference.

.14 Successor Accountant's Compilation Report on Current-Period Financial Statements That Refers to a Predecessor Accountant's Compilation Report on Prior-Period Financial Statements

Addressee:

I (We) have compiled the accompanying balance sheet of XYZ Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended, 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 19X2 financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

The 19X1 financial statements of XYZ Company were compiled by other accountants whose report dated February 1, 19X2, stated that they did not express an opinion or any other form of assurance on those statements.

[*Signature*]

[*Date*]

[Sources: SSARS 2, paragraph 19 (AR section 200.19) and SSARS 1, paragraph 17, as amended by SSARS 7 (AR section 100.17).]

NOTE:

Statements on Standards for Accounting and Review Services provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity, or a public entity as noted in SSARS 7.

.15 Successor Accountant's Compilation Report on Current-Period Financial Statements That Refers to a Predecessor Accountant's Review Report on Prior-Period Financial Statements

Addressee:

I (We) have compiled the accompanying balance sheet of XYZ Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended, 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 19X2 financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

The 19X1 financial statements of XYZ Company were reviewed by other accountants whose report dated March 1, 19X2, 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.

[*Signature*]

[*Date*]

[Sources: SSARS 2, paragraph 18 (AR section 200.18) and SSARS 1, paragraph 17, as amended by SSARS 7 (AR section 100.17).]

NOTE:

Statements on Standards for Accounting and Review Services provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity, or a public entity as noted in SSARS 7.

.16 Continuing Accountant's Report on Comparative Statements—Current Period Compiled With Reference to Audit Report on Prior Period

Addressee:

I (We) have compiled the accompanying balance sheet of XYZ Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended, 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 19X2 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, 19X1, were audited by me (us) (other accountants) and I (we) (they) expressed an unqualified opinion on them in my (our) (their) report dated March 1, 19X2, but I (we) (they) have not performed any auditing procedures since that date.

[*Signature*]

[*Date*]

[Sources: SSARS 2, paragraph 28 (AR section 200.28) and SSARS 1, paragraph 17, as amended by SSARS 7 (AR section 100.17).]

NOTE:

Statements on Standards for Accounting and Review Services provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity, or a public entity as noted in SSARS 7.

.17 Continuing Accountant's Compilation Report on Comparative Statements—Prior Period Financial Statements Compiled With Substantially All Disclosures Omitted From Previously Compiled (Reviewed) Financial Statements

Addressee:

I (We) have compiled the accompanying balance sheets of XYZ Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

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

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

The accompanying 19X1 financial statements were compiled by me (us) from financial statements that did not omit substantially all of the disclosures required by generally accepted accounting principles and that I (we) previously compiled (reviewed) as indicated in my (our) report dated March 1, 19X2.

[*Signature*]

[*Date*]

[Source: SSARS 2, paragraph 30, as amended by SSARS 7 (AR section 200.30).]

NOTE:

Statements on Standards for Accounting and Review Services provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity, or a public entity as noted in SSARS 7.

.18 Compilation Report—Financial Statements Accompanied by Supplementary Information

Addressee:

I (We) have compiled the accompanying balance sheet of XYZ Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended, and the accompanying supplementary information (*identify the supplementary information, for example, schedules of cost of goods sold and selling, general and administrative expenses*), which are presented only for supplementary analysis purposes, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of financial statements and supplementary schedules information that is the representation of management (owners). 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.

[*Signature*]

[*Date*]

[Source: SSARS 1, paragraph 43, as amended by SSARS 7 (AR section 100.43).]

NOTE:

Statements on Standards for Accounting and Review Services provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity, or a public entity as noted in SSARS 7.

.19 Financial Statements Included in Certain Prescribed Forms

Addressee:

I (We) have compiled the accompanying balance sheet of XYZ Company as of December 31, 19XX, 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 ABC Bank information that is the representation of management (owners). I (We) have not audited or reviewed the financial statements referred to above and, accordingly, do not express an opinion or any other form of assurance on them.

These financial statements (including related disclosures) are presented in accordance with the requirements of [*name of body*], which differ from generally accepted accounting principles. Accordingly, these financial statements are not designed for those who are not informed about such differences.

[*Signature*]

[*Date*]

[Source: SSARS 3, paragraph 3, as amended by SSARS 7 (AR section 300.03).]

NOTE:

Statements on Standards for Accounting and Review Services provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity, or a public entity as noted in SSARS 7. SSARS 3 (AR section 300), provides for an alternative form of standard compilation report when a prescribed form or related instructions call for departure from generally accepted accounting principles or another comprehensive basis of accounting.

.20 Financial Statements Included in Certain Prescribed Forms—Departure from GAAP Not Called for by the Prescribed Forms

Addressee:

I (We) have compiled the accompanying balance sheet of XYZ Company as of December 31, 19XX, 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 ABC Trade Association information that is the representation of management (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. However, I (we) did become aware of a departure from generally accepted accounting principles that is not called for by the prescribed form or related instructions, as described in the following paragraph.

As disclosed in note X to the financial statements, generally accepted accounting principles require that land be stated at cost. Management has informed me (us) that the company has stated its land at appraised value and that, if generally accepted accounting principles had been followed, the land account and stockholders' equity would have been decreased by $XXX,XXX.

These financial statements (including related disclosures) are otherwise presented in accordance with the requirements of [*name of body*], which also differ from generally accepted accounting principles. Accordingly, these financial statements are not designed for those who are not informed about such differences.

[*Signature*]

[*Date*]

[Source: SSARS 3, paragraph 4, as amended by SSARS 7 (AR section 300.04).]

NOTE:

Statements on Standards for Accounting and Review Services provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity, or a public entity as noted in SSARS 7. SSARS 3 (AR section 300), provides for an alternative form of standard compilation report when a prescribed form or related instructions call for departure from generally accepted accounting principles or another comprehensive basis of accounting.

.21 Uncertainty With Note Disclosure—Entity's Continued Existence ("Going Concern")

Addressee:

I (We) have compiled the accompanying balance sheet of XYZ Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

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

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

[*Signature*]

[*Date*]

[Sources: SSARS 1, paragraph 40, as amended by SSARS 7 (AR section 100.40) and Accounting and Review Services Interpretation No. 11 of SSARS 1 (AR section 100.40 and AR section 9100.33—.40).]

NOTE:

Statements on Standards for Accounting and Review Services provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity, or a public entity as noted in SSARS 7.

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* Although not a requirement, an accountant may wish to draw attention to an uncertainty in an explanatory paragraph of the compilation report, including disclosure of the effects of the departure on the financial statements if such effects have been determined by management or are known as a result of the accountant's procedures.

.22 Interim Historical Financial Statements Accompanied by a Financial Forecast Labeled as a "Budget"

Addressee:

I (We) have compiled the accompanying balance sheet of XYZ Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the six months 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.

The accompanying budgeted balance sheet, statements of income, retained earnings, and cash flows of XYZ Company as of December 31, 19XX, and for the six months then ending, have not been compiled or examined by us and, accordingly, we do not express an opinion or any other form of assurance on them.

Management has (The owners have) elected to omit the summaries of significant assumptions and accounting policies required under established guidelines for presentation of prospective financial statements. If the omitted summaries were included in the budgeted information, they might influence the user's conclusions about the company's budgeted information. Accordingly, this budgeted information is not designed for those who are not informed about such matters.

[*Signature*]

[*Date*]

[Source: SSARS 1, paragraph 17, as amended by SSARS 7 (AR section 100.17) and Statement on Standards for Accountants' Services on Prospective Financial Information, *Financial Forecasts and Projections,* paragraph 58 (AT section 200.58).]

.23 Interim Historical Financial Statements Accompanied by a Financial Forecast Labeled as an "Annual Budget"

Addressee:

I (We) have compiled the accompanying balance sheet of XYZ Company as of June 30, 19XX, and the related statements of income, retained earnings, and cash flows for the six month period then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of financial statements information that is the representation of 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.

The accompanying annual budget of XYZ Company for the year ending December 31, 19XX has not been compiled or examined by us and, accordingly, we do not express an opinion or any other form of assurance on it.

Management has (The owners have) elected to omit the summaries of significant assumptions and accounting policies required under established guidelines for presentation of prospective financial statements. If the omitted summaries were included in the budgeted information, they might influence the user's conclusions about the company's budgeted information. Accordingly, this budgeted information is not designed for those who are not informed about such matters.

[*Signature*]

[*Date*]

[Source: SSARS 1, paragraph 17, as amended by SSARS 7 (AR section 100.17) and Statement on Standards for Accountants' Services on Prospective Financial Information, *Financial Forecasts and Projections,* paragraph 58 (AT section 200.58).]

.24 Comparative Statements—Current Year Compiled and Prior Year Audited by a Different Accountant Who Has Ceased Operations

Addressee:

I (We) have compiled the accompanying balance sheet of XYZ Company as of December 31, 19X2 and the related statements of income, retained earnings, and cash flows for the years then ended, in accordance with the 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 19X2 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, 19X1, were audited by other accountants who have ceased operations, and they expressed an unqualified opinion on them in their report dated March 1, 19X2, but they have not performed any auditing procedures since that date.

[*Signature*]

[*Date*]

[Sources: SSARS 1, paragraph 17, as amended by SSARS 7 (AR section 100.17), SSARS 2, paragraphs 17 and 19 (AR section 200.17 and .19) and Notice to Practitioners, February 1991, *Audit, Review, and Compilation Considerations When a Predecessor Accountant Has Ceased Operations,* paragraph 8.]

.25 Comparative Statements—Both Years Compiled; However, Prior Year by a Different Accountant Who Has Ceased Operations

Addressee:

I (We) have compiled the accompanying balance sheet of XYZ Company as of December 31, 19X2 and the related statements of income, retained earnings, and cash flows for the years then ended, in accordance with the 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.

The 19X1 financial statements of XYZ Company were compiled by other accountants who have ceased operations and whose report dated February 1, 19X2, stated that they did not express an opinion or any other form of assurance on those statements.

[*Signature*]

[*Date*]

[Sources: SSARS 1, paragraph 17, as amended by SSARS 7 (AR section 100.17), SSARS 2, paragraphs 17 and 19, (AR section 200.17 and .19) and Notice to Practioners, February 1991, *Audit, Review, and Compilation Considerations When a Predecessor Accountant Has Ceased Operations,* paragraph 8.]

.26 Prescribed-Form Compilation Report For BCIP, Accompanying Supplementary Information Has Been Compiled

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____

____

I (We) have compiled the ____________________ [*Identify Financial Statements, Including Periods Presented and Name of Client*] included in the accompanying Business Credit Information Package in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. I (We) have also compiled the supplementary information presented in the Business Credit Information Package.

My (Our) compilation was limited to presenting in the form designed by Robert Morris Associates (the "Business Credit Information Package") and requested by __________ [*Name of Bank*] information that is the representation of management. I (We) have not audited or reviewed the financial statements or supplementary information 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) and supplementary information are for the use of __________ [*Name of Bank*] and are presented in accordance with the requirements of the Business Credit Information Package, which differ from generally accepted accounting principles. Accordingly, these financial statements and supplementary information are not designed for those who are not informed about such differences.

[*Firm's Signature*]

____________ [*Report Date*]

[The next page is 10,771.]

AAM Section 10,500

Accountant's Report on Review of Financial Statements of a Nonpublic Entity

.01 Accountant's Standard Report

Addressee:

I (We) have reviewed the accompanying balance sheet of XYZ Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management (owners) of XYZ Company.

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.

[*Signature*]

[*Date*]

[Source: SSARS 1, paragraph 35, as amended by SSARS 7 (AR section 100.35).]

NOTE:

Statements on Standards for Accounting and Review Services provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity, or a public entity as noted in SSARS 7.

.02 Departure From GAAP—Accounting Principle Not Generally Accepted

Addressee:

I (We) have reviewed the accompanying balance sheet of XYZ Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management (owners) of XYZ Company.

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 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.

[*Signature*]

[*Date*]

[Source: SSARS 1, paragraph 40, as amended by SSARS 7 (AR section 100.40).]

NOTE:

Statements on Standards for Accounting and Review Services provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity, or a public entity as noted in SSARS 7.

.03 Departure From GAAP—Change in Accounting Principle Without Reasonable Justification

Addressee:

I (We) have reviewed the accompanying balance sheet of XYZ Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management (owners) of XYZ Company.

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, the company has adopted (description of newly adopted method), whereas it previously used (description of previous method). Although the (description of newly adopted method) is in conformity with generally accepted accounting principles, the company does not appear to have reasonable justification for making a change as required by Opinion No. 20 of the Accounting Principles Board.

[*Signature*]

[*Date*]

[Source: SSARS 1, paragraph 40, as amended by SSARS 7 (AR section 100.40).]

NOTE:

Statements on Standards for Accounting and Review Services provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity, or a public entity as noted in SSARS 7.

.04 Departure From GAAP—Omission of Statement of Cash Flows

Addressee:

I (We) have reviewed the accompanying balance sheet of XYZ Company as of December 31, 19XX, and the related statements of income, and retained earnings, for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management (owners) of XYZ Company.

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

Based on my (our) review, with the exception of the matter described in the following paragraph, I 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, 19XX, 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.

[*Signature*]

[*Date*]

[Source: SSARS 1, paragraph 40, as amended by SSARS 7 (AR section 100.40).]

NOTE:

Statements on Standards for Accounting and Review Services provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity, or a public entity as noted in SSARS 7.

.05 Cash Basis Statements—Full Disclosure

Addressee:

I (We) have reviewed the accompanying statement of assets and liabilities arising from cash transactions of XYZ Company as of December 31, 19XX, and the related statement of revenue collected and expenses paid for the year 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.

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.

[*Signature*]

[*Date*]

[Source: Accounting and Review Services Interpretation No. 12 of SSARS 1, as amended by SSARS 7 (AR section 9100.45).]

NOTES:

1) Statements on Standards for Accounting and Review Services provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity, or a public entity as noted in SSARS 7.

2) When financial statements are prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles, the notes ordinarily would state the basis of presentation and describe how that basis differs from generally accepted accounting principles.

.06 Income Tax Basis Statements—Full Disclosure

Addressee:

I (We) have reviewed the accompanying statement of assets, liabilities, and equity—income tax basis of XYZ Company as of December 31, 19XX, and the related statement of revenue and expenses—income tax basis for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management (owners) of XYZ Company.

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

Based on my (our) review, I 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.

[*Signature*]

[*Date*]

[Source: Accounting and Review Services Interpretation No. 12 of SSARS 1, as amended by SSARS 7 (AR section 9100.41—.45).]

NOTES:

1) Statements on Standards for Accounting and Review Services provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity, or a public entity as noted in SSARS 7.

2) When financial statements are prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles, the notes ordinarily would state the basis of presentation and describe how that basis differs from generally accepted accounting principles.

.07 Continuing Accountant's Report on Comparative Statements—Both Periods Reviewed

Addressee:

I (We) have reviewed the accompanying balance sheets of XYZ Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management (owners) of XYZ Company.

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

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

[*Signature*]

[*Date*]

[Source: SSARS 2, paragraph 9, as amended by SSARS 7 (AR section 200.09).]

NOTE:

Statements on Standards for Accounting and Review Services provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity, or a public entity as noted in SSARS 7.

.08 Continuing Accountant's Report on Comparative Statements—Current Period Reviewed and Prior Period Compiled

Addressee:

I (We) have reviewed the accompanying balance sheet of XYZ Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended, 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.

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 19X2 financial statements in order for them to be in conformity with generally accepted accounting principles.

The accompanying 19X1 financial statements of XYZ Company were compiled by me (us). 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 19X1 financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

[*Signature*]

[*Date*]

[Source: SSARS 2, paragraph 10, as amended by SSARS 7 (AR section 200.10).]

NOTE:

Statements on Standards for Accounting and Review Services provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity, or a public entity as noted by SSARS 7.

.09 Continuing Accountant's Report on Comparative Statements—Both Periods Reviewed With Restatement of Prior-Period Financial Statements[1]

Addressee:

I (We) have reviewed the accompanying balance sheet of XYZ Company as of December 31, 19X2 and 19X1, the related statements of income, retained earnings, and cash flows for the years then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management (owners) of XYZ Company.

A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less is 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.

In my (our) previous review report dated March 1, 19X2, on the 19X1 financial statements, I (we) referred to a departure from generally accepted accounting principles because the company carried its land at appraised values. However, as disclosed in Note X, the company has restated its 19X1 financial statements to reflect its land at cost in accordance with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Sources: SSARS 2, paragraph 15, as amended by SSARS 7 (AR section 200.15) and SSARS 1, paragraph 35, as amended by SSARS 7 (AR section 100.35).]

NOTE:

Statements on Standards for Accounting and Review Services provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity, or a public entity as noted in SSARS 7.

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[1] A changed reference to a departure from generally accepted accounting principles includes the removal of a prior reference or the inclusion of a new reference.

.10 Successor Accountant's Review Report on Current-Period Financial Statements That Refers to a Predecessor Accountant's Review Report on Prior-Period Financial Statements

Addressee:

I (We) have reviewed the accompanying balance sheet of XYZ Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended, 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.

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 19X2 financial statements in order for them to be in conformity with generally accepted accounting principles.

The 19X1 financial statements of XYZ Company were reviewed by other accountants whose report dated March 1, 19X2, 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.

[*Signature*]

[*Date*]

[Sources: SSARS 2, paragraph 18, as amended by SSARS 7 (AR section 200.18) and SSARS 1, paragraph 35, as amended by SSARS 7 (AR section 100.35).]

NOTE:

Statements on Standards for Accounting and Review Services provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity, or a public entity as noted in SSARS 7.

.11 Successor Accountant's Review Report on Current-Period Financial Statements That Refers to a Predecessor Accountant's Compilation Report on Prior-Period Financial Statements

Addressee:

I (We) have reviewed the accompanying balance sheet of XYZ Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended, 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.

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 19X2 financial statements in order for them to be in conformity with generally accepted accounting principles.

The 19X1 financial statements of XYZ Company were compiled by other accountants whose report dated February 1, 19X2, stated that they did not express an opinion or any other form of assurance on those statements.

[*Signature*]

[*Date*]

[Sources: SSARS 2, paragraph 19, as amended by SSARS 7 (AR section 200.19) and SSARS 1, paragraph 35, as amended by SSARS 7 (AR section 100.35).]

NOTE:

Statements on Standards for Accounting and Review Services provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity, or a public entity as noted in SSARS 7.

.12 Continuing Accountant's Report on Comparative Statements—Current Period Reviewed With Reference to Audit Report on Prior Period

Addressee:

I (We) have reviewed the accompanying balance sheet of XYZ Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended, 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.

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 19X2 financial statements in order for them to be in conformity with generally accepted accounting principles.

The financial statements for the year ended December 31, 19X1, were audited by me (us) (other accountants) and I (we) (they) expressed an unqualified opinion on them in my (our) (their) report dated March 1, 19X2, but I (we) (they) have not performed any auditing procedures since that date.

[*Signature*]

[*Date*]

[Sources: SSARS 2, paragraph 28 (AR section 200.28) and SSARS 1, paragraph 35, as amended by SSARS 7 (AR section 100.35).]

NOTE:

Statements on Standards for Accounting and Review Services provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity, or a public entity as noted in SSARS 7.

.13 Review Report—Supplementary Information Subjected to Review Procedures

Addressee:

I (We) have reviewed the accompanying balance sheet of XYZ Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management (owners) of XYZ Company.

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 the accompanying (identify the supplementary information, for example, schedules of cost of goods sold and selling, general, and administrative expenses) is presented only for supplementary analysis purposes. Such information has been subjected to the inquiry and analytical procedures applied in the review of the basic financial statements and I am (we are) not aware of any material modifications that should be made thereto.

[*Signature*]

[*Date*]

[Source: SSARS 1, paragraph 43, as amended by SSARS 7 (AR section 100.43).]

NOTE:

Statements on Standards for Accounting and Review Services provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity, or a public entity as noted in SSARS 7.

.14 Review Report—Supplementary Information Not Subjected to Review Procedures

Addressee:

I (We) have reviewed the accompanying balance sheet of XYZ Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management (owners) of XYZ Company.

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 the accompanying (identify the supplementary information, for example, schedules of cost of goods sold and selling, general, and administrative expenses) is presented only for supplementary analysis purposes. Such information has not been subjected to the inquiry and analytical procedures applied in the review of the basic financial statements, but was compiled from information that is the representation of management, without audit or review. Accordingly, I (we) do not express an opinion or any other form of assurance on the supplementary information.

[*Signature*]

[*Date*]

[Source: SSARS 1, paragraph 43, as amended by SSARS 7 (AR section 100.43).]

NOTE:

Statements on Standards for Accounting and Review Services provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity, or a public entity as noted in SSARS 7.

.15 Review Report—Emphasis of a Going Concern Uncertainty

Addressee:

I (We) have reviewed the accompanying balance sheet of XYZ Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management (owners) of XYZ Company.

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.

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

[*Signature*]

[*Date*]

[Sources: SSARS 1, paragraph 40, as amended by SSARS 7 (AR section 100.40) and Accounting and Review Services Interpretation No. 11 of SSARS 1 (AR section 9100.38).]

NOTE:

Statements on Standards for Accounting and Review Services provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity, or a public entity as noted in SSARS 7.

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* Although not a requirement, an accountant may wish to draw attention to an uncertainty in an explanatory paragraph of his review report including disclosure of the effects of the departure on the financial statements if such effects have been determined by management or are known as a result of the accountant's procedures.

.16 Comparative Statements—Both Years Reviewed; However, Prior Year by a Different Accountant Who Has Ceased Operations

Addressee:

I (We) have reviewed the accompanying balance sheet of XYZ Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended, 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.

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 conformity with generally accepted accounting principles.

The 19X1 financial statements of XYZ Company were reviewed by other accountants who have ceased operations and whose report dated February 1, 19X2, 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.

[*Signature*]

[*Date*]

[Sources: SSARS 1, paragraph 35, as amended by SSARS 7 (AR section 100.35), SSARS 2, paragraphs 17 and 18 (AR section 200.17 and .18) and Notice to Practitioners, February 1991, *Audit, Review, and Compilation Considerations When a Predecessor Accountant Has Ceased Operations*, paragraph 8.]

.17 Comparative Statements—Current Year Reviewed and Prior Year Audited by a Different Accountant Who Has Ceased Operations

Addressee:

I (We) have reviewed the accompanying balance sheet of XYZ Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended, 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.

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 statments in order for them to be in conformity with generally accepted accounting principles.

The financial statements for the year ended December 31, 19X1, were audited by other accountants who have ceased operations, and they expressed an unqualified opinion on them in their report dated March 1, 19X2, but they have not performed any auditing procedures since that date.

[*Signature*]

[*Date*]

[Sources: SSARS 1, paragraph 35, as amended by SSARS 7 (AR section 100.35), SSARS 2, paragraphs 17 and 18 (AR section 200.17 and .18) and Notice to Practitioners, February 1991, *Audit, Review, and Compilation Considerations When a Predecessor Accountant Has Ceased Operations,* paragraph 8.]

.18 Review Report on Elements, Accounts, or Items of a Financial Statement Under the Attestation Standards

____

____

____

I (We) have reviewed the accompanying __________ [*Identify the Schedules(s) of Elements, Accounts or Items*] of __________ [*Client Name*] for the ______ [*Period*] ended __________. My (Our) review was conducted in accordance with standards established by the American Institute of Certified Public Accountants.

A review is substantially less in scope than an audit, the objective of which is the expression of an opinion on the ______________ [*Identify the Schedule(s) of Elements, Accounts or Items*]. Accordingly, I (we) do not express such an opinion.[1]

Based on my (our) review, nothing came to my (our) attention that caused me (us) to believe that the accompanying ______________ [*Identify the Schedule(s) of Elements, Accounts or Items*] is (are) not presented in conformity with generally accepted accounting principles (or other identified basis of accounting).

[*Firm's signature*]

________________ [*Report Date*]

[The next page is 10,791.]

[1] An additional explanatory paragraph may be added after the second paragraph to emphasize matters relating to the presentation of the element or the review engagement.

AAM Section 10,550

Accountant's Report on Condensed Financial Statements and Selected Financial Data

.01 Unqualified Opinion on Condensed Financial Statements[1]

Independent Auditor's Report

Addressee:

We have audited, in accordance with generally accepted auditing standards, the consolidated balance sheet of X Company and subsidiaries as of December 31, 19X0, and the related consolidated statements of income, retained earnings, and cash flows for the year then ended (not presented herein); and in our report dated February 15, 19X1, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated financial statements is fairly stated in all material respects in relation to the consolidated financial statements from which it has been derived.

[*Signature*]

[*Date*]

[Source: SAS No. 42, paragraph 6 (AU section 552.06).]

[1] This report is appropriate when reporting in a client-prepared document on condensed financial statements (either for an annual or an interim period) that are derived from audited financial statements of a public entity that is required to file, at least annually, complete audited financial statements with a regulatory agency (See SAS No. 42, paragraph 1a [AU section 552.019]).

.02 Adverse Opinion on Condensed Financial Statements Due to Inadequate Disclosure[2]

Independent Auditor's Report

Addressee:

We have audited the consolidated balance sheet of X Company and subsidiaries as of December 31, 19X0, and the related consolidated statements of income, retained earnings, and cash flows for the year then ended (not presented herein). Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The condensed consolidated balance sheet as of December 31, 19X0, and the related condensed consolidated statements of income, retained earnings, and cash flows for the year then ended, presented on pages XX-XX, are presented as a summary and therefore do not include all of the disclosures required by generally accepted accounting principles.

In our opinion, because of the significance of the omission of the information referred to in the preceding paragraph, the condensed consolidated financial statements referred to above do not present fairly, in conformity with generally accepted accounting principles, the financial position of X Company and subsidiaries as of December 31, 19X0, or the results of their operations and their cash flows for the year then ended.

[*Signature*]

[*Date*]

[Source: SAS No. 42, paragraph 7, footnote 6 (AU section 552.07).]

[2] If a statement naming the auditor and stating that condensed financial statements have been derived from audited financial statements is made in a client-prepared document that does not include audited financial statements and the client is not a public entity that is required to file complete audited financial statements with a regulatory agency at least annually, this report is appropriate (See SAS 42, paragraph 7, footnote 6 [AU section 552.07]).

.03 Review Report on Condensed Financial Statements

Independent Auditor's Report

Addressee:

We have reviewed the condensed consolidated balance sheet of ABC Company and subsidiaries as of March 31, 19X1, and the related condensed consolidated statements of income and cash flows for the three-month periods ended March 31, 19X1 and 19X0. These financial statements are the responsibility of the company's management.

We conducted our review in accordance with standards established by the American Institute of Certified Public Accountants. A review of interim financial information consists principally of applying analytical procedures to financial data and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the condensed consolidated financial statements referred to above for them to be in conformity with generally accepted accounting principles.

We have previously audited, in accordance with generally accepted auditing standards, the consolidated balance sheet as of December 31, 19X0, and the related consolidated statements of income, retained earnings, and cash flows for the year then ended (not presented herein); and in our report dated February 15, 19X1, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 19X0, is fairly stated in all material respects in relation to the consolidated balance sheet from which it has been derived.

[*Signature*]

[*Date*]

[Source: SAS No. 42, paragraph 8, as amended by SAS No. 71 (AU section 552.08).]

[The next page is 10,851.]

AAM Section 10,600
Reports on Personal Financial Statements

.01 Auditor's Standard Report

Independent Auditor's Report

Addressee:

I (We) have audited the statement of financial condition of James and Jane Person as of [*date*], and the related statement of changes in net worth for the [*period*] then ended. These financial statements are the responsibility of James and Jane Person. My (our) responsibility is to express an opinion on these financial statements based on my (our) audit.

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

In my (our) opinion, the financial statements referred to above present fairly, in all material respects, the financial condition of James and Jane Person as of [*date*] and the changes in their net worth for the [*period*] then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: AICPA *Personal Financial Statements Guide.*]

.02 Audit Report—Statement of Financial Condition Only

Independent Auditor's Report

Addressee:

I (We) have audited the statement of financial condition of James and Jane Person as of [*date*]. This financial statement is the responsibility of James and Jane Person. My (our) responsibility is to express an opinion on this financial statement based on my (our) audit.

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

In my (our) opinion, the financial statement referred to above presents fairly, in all material respects, the financial condition of James and Jane Person as of [*date*] in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: AICPA *Personal Financial Statements Guide.*]

.03 Audit Report—Departure from GAAP—Inappropriate Valuation Methods—Adverse Opinion

Independent Auditor's Report

Addressee:

I (We) have audited the statement of financial condition of James and Jane Person as of [*date*], and the related statement of changes in net worth for the [*period*] then ended. These financial statements are the responsibility of James and Jane Person. My (our) responsibility is to express an opinion on these financial statements based on my (our) audit.

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

As discussed in Note X to the financial statements, assets amounting to $XX,XXX (XX percent of total assets) as of [*date*] have been valued at estimated current value as determined by James Person. I (We) have reviewed the procedures applied by James Person in valuing the assets and have inspected the underlying documentation. In my (our) opinion, those procedures are not appropriate to determine the estimated current values of the assets in conformity with generally accepted accounting principles. The effects on the financial statements of not applying appropriate procedures to determine the estimated current values of the assets are not reasonably determinable.

In my (our) opinion, because of the effects of the matters discussed in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with generally accepted accounting principles, the financial condition of James and Jane Person as of [*date*] and the changes in their net worth for the [*period*] then ended.

[*Signature*]

[*Date*]

[Source: AICPA *Personal Financial Statements Guide.*]

.04 Audit Report—Departure from GAAP—Inappropriate Valuation Methods—Qualified Opinion

Independent Auditor's Report

Addressee:

I (We) have audited the statement of financial condition of James and Jane Person as of [*date*], and the related statement of changes in net worth for the [*period*] then ended. These financial statements are the responsibility of James and Jane Person. My (our) responsibility is to express an opinion on these financial statements based on my (our) audit.

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

As discussed in Note X to the financial statements, assets amounting to $XX,XXX (XX percent of total assets) as of [*date*] have been valued at estimated current value as determined by James Person. I (We) have reviewed the procedures applied by James Person in valuing the assets and have inspected the underlying documentation. In my (our) opinion, those procedures are not appropriate to determine the estimated current values of the assets in conformity with generally accepted accounting principles. The effects on the financial statements of not applying appropriate procedures to determine the estimated current values of the assets are not reasonably determinable.

In my (our) opinion, except for the effects on the financial statements of the valuation of assets determined by James Person, as described in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial condition of James and Jane Person as of [*date*] and the changes in their net worth for the [*period*] then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: AICPA *Personal Financial Statements Guide.*]

.05 Audit Report—Inadequate Records Preclude Opinion

Independent Auditor's Report

Addressee:

I (We) was engaged to audit the statement of financial condition of James and Jane Person as of [*date*], and the related statement of changes in net worth for the [*period*] then ended. These financial statements are the responsibility of James and Jane Person.

James and Jane Person do not maintain accounting records sufficient to assure that all transactions are recorded. Accordingly, it was not practicable for me (us) to extend my (our) auditing procedures sufficiently to determine that all of their assets and liabilities and the changes in their net worth are recorded in the financial statements referred to above.

Because James and Jane Person do not maintain certain accounting records and supporting documentation, and because I was (we were) unable to apply adequate auditing procedures regarding the recording of transactions as noted in preceding paragraph, the scope of my (our) work was not sufficient to enable me (us) to express, and I (we) do not express, an opinion on the financial statements referred to above.

[*Signature*]

[*Date*]

[Source: AICPA *Personal Financial Statements Guide.*]

.06 Audit Report—Scope Limitation—Inadequate Records

Independent Auditor's Report

Addressee:

I (We) have audited the statement of financial condition of James and Jane Person as of [*date*], and the related statement of changes in net worth for the [*period*] then ended. These financial statements are the responsibility of James and Jane Person. My (our) responsibility is to express an opinion on these financial statements based on my (our) audit.

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

James and Jane Person do not maintain accounting records sufficient to assure that all transactions are recorded. Accordingly, it was not practicable for me (us) to extend my (our) auditing procedures sufficiently to determine that all of their assets and liabilities and the changes in their net worth are recorded in the financial statements referred to above.

In my (our) opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had I (we) been able to determine that all assets and liabilities and changes in net worth were recorded in the financial statements, the financial statements referred to above present fairly, in all material respects, the financial condition of James and Jane Person as of [*date*], and the changes in their net worth for the [*period*] then ended, in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: AICPA *Personal Financial Statements Guide.*]

.07 Audit Report—Income Tax Basis

Independent Auditor's Report

Addressee:

I (We) have audited the statement of assets and liabilities—income tax basis of James and Jane Person as of [*date*], and the related statement of changes in net assets—income tax basis for the [*period*] then ended. These financial statements are the responsibility of James and Jane Person. My (Our) responsibility is to express an opinion on these financial statements based on my (our) audit.

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

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

In my (our) opinion, the financial statements referred to above present fairly, in all material respects, the assets and liabilities of James and Jane Person as of [*date*], and the changes in their net assets for the [*period*] then ended, on the basis of accounting described in Note X.

[*Signature*]

[*Date*]

[Sources: SAS No. 62, paragraph 8 (AU section 623.08) and AICPA *Personal Financial Statements Guide.*]

.08 Accountant's Standard Compilation Report

Addressee:

I (We) have compiled the accompanying statement of financial condition of James and Jane Person as of [*date*], and the related statement of changes in net worth for the [*period*] then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

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

[*Signature*]

[*Date*]

[Source: AICPA *Personal Financial Statements Guide.*]

.09 Compilation Report—Statement of Financial Condition Only

Addressee:

I (We) have compiled the accompanying statement of financial condition of James and Jane Person as of [*date*], in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

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

[*Signature*]

[*Date*]

[Source: AICPA *Personal Financial Statements Guide.*]

.10 Compilation Report—Omission of Substantially All Disclosures

Addressee:

I (We) have compiled the accompanying statement of financial condition of James and Jane Person as of [*date*], and the related statement of changes in net worth for the [*period*] then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

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

James and Jane Person have elected to omit substantially all of the disclosures required by generally accepted accounting principles. If the omitted disclosures were included in the financial statements, they might influence the user's conclusions about the financial condition of James and Jane Person and changes in their net worth. Accordingly, these financial statements are not designed for those who are not informed about such matters.

[*Signature*]

[*Date*]

[Source: AICPA *Personal Financial Statements Guide.*]

NOTE:

When personal financial statements omit substantially all disclosures and do not disclose that the assets are presented at their estimated current values and that the liabilities are presented at their estimated current amounts, the accountant should include the following sentence at the end of the first paragraph of his report:

> The financial statements are intended to present the assets of James and Jane Person at estimated current values and their liabilities at estimated current amounts.

.11 Compilation Report—GAAP Departure—Material Assets at Cost

Addressee:

I (We) have compiled the accompanying statement of financial condition of James and Jane Person as of [*date*], and the related statement of changes in net worth for the [*period*] then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of financial statements information that is the representation of the individuals whose financial statements are presented. I (We) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them. However, I (we) did become aware of a departure from generally accepted accounting principles that is described in the following paragraph.

As disclosed in Note X to the financial statements, generally accepted accounting principles require that assets be presented at their estimated current values and that liabilities be presented at their estimated current amounts. James and Jane Person have informed me (us) that their investment in ABC Company is stated in the accompanying financial statements at cost and that the effects of this departure from generally accepted accounting principles on their financial condition and the changes in their net worth have not been determined.

[*Signature*]

[*Date*]

[Source: AICPA *Personal Financial Statements Guide.*]

.12 Compilation Report—Income Tax Basis

Addressee:

I (We) have compiled the accompanying statement of assets and liabilities—income tax basis of James and Jane Person as of [*date*], and the related statement of changes in net assets—income tax basis for the [*period*] then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

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

[*Signature*]

[*Date*]

[Source: AICPA *Personal Financial Statements Guide.*]

NOTE:

When personal financial statements are prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles, the notes ordinarily would state the basis of presentation and describe how that basis differs from generally accepted accounting principles. [Source: Accounting and Review Services Interpretation No. 12 of SSARS 1 (AR section 9100.45).]

.13 Compilation Report—Financial Statements Included in a Prescribed Form

Addressee:

I (We) have compiled the [*identification of financial statements, including period covered and name of individual(s)*] included in the accompanying prescribed form, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

My (Our) compilation was limited to presenting in the form prescribed by [*name of body*] information that is the representation of the individuals whose financial statements are presented. I (We) have not audited or reviewed the financial statements referred to above and, accordingly, do not express an opinion or any other form of assurance on them.

These financial statements (including related disclosures) are presented in accordance with the requirements of [*name of body*], which differ from generally accepted accounting principles. Accordingly, these financial statements are not designed for those who are not informed about such differences.

[*Signature*]

[*Date*]

[Source: AICPA *Personal Financial Statements Guide.*]

.14 Accountant's Standard Review Report

Addressee:

I (We) have reviewed the accompanying statement of financial condition of James and Jane Person as of [*date*], and the related statement of changes in net worth for the [*period*] then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of James and Jane Person.

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

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

[*Signature*]

[*Date*]

[Source: AICPA *Personal Financial Statements Guide.*]

.15 Review Report—Statement of Financial Condition Only

Addressee:

I (We) have reviewed the accompanying statement of financial condition of James and Jane Person as of [*date*], in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in this financial statement is the representation of James and Jane Person.

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

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

[*Signature*]

[*Date*]

[Source: AICPA *Personal Financial Statements Guide*.]

.16 Review Report—GAAP Departure—Failure to Include a Provision for Estimated Income Taxes on the Differences Between the Estimated Current Values of Assets and the Estimated Current Amounts of Liabilities and Their Tax Bases

Addressee:

I (We) have reviewed the accompanying statement of financial condition of James Person as of [*date*], and the related statement of changes in net worth for the [*period*] then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of James Person.

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

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

Generally accepted accounting principles require that personal financial statements include a provision for estimated income taxes on the differences between the estimated current values of assets and the estimated current amounts of liabilities and their tax bases. The accompanying financial statements do not include such a provision and the effect of this departure from generally accepted accounting principles has not been determined.

[*Signature*]

[*Date*]

[Source: AICPA *Personal Financial Statements Guide.*]

.17 Review Report—Income Tax Basis

Addressee:

I (We) have reviewed the accompanying statement of assets and liabilities—income tax basis of James and Jane Person as of [*date*], and the related statement of changes in net assets—income tax basis for the [*period*] then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of James and Jane Person.

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

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with the income tax basis of accounting described in Note X.

[*Signature*]

[*Date*]

[Source: AICPA *Personal Financial Statements Guide.*]

[The next page is 10,901.]

AAM Section 10,700

Accountants' Reports on Basic or General Purpose Financial Statements for State and Local Governmental Units

.01 Unqualified Opinion on General Purpose or Component Unit Financial Statements Only

Independent Auditor's Report

Addressee:

We have audited the accompanying general purpose* financial statements of City of Example, Any State as of December 31, 19XX, and for the year then ended. These general purpose financial statements are the responsibility of City of Example, Any State management. Our responsibility is to express an opinion on these general purpose 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 general purpose financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the general purpose financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall general purpose financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the general purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State as of December 31, 19XX, and the results of its operations and cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SOP 92-7, *Audits of State and Local Governmental Entities Receiving Federal Federal Assistance.*]

* If the financial statements are for a component unit, the term "general purpose financial statements" should not be used. In the case of a component unit, the term "component unit financial statements" or just "financial statements" should be used. For the component unit financial statements of an oversight unit see AAM section 10,700.04.

** For government financial audits, a statement should be included in the auditor's report that the audit was made in accordance with generally accepted government auditing standards . . . Federal reviewers have accepted reports on the general purpose financial statements, but not other reports that do not refer to *Government Auditing Standards* . . . The auditor is permitted to refer to both generally accepted auditing standards and *Government Auditing Standards* in the auditor's report. In report examples AAM section 10,700.01-.15 the following can be used: ". . . we conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards* issued by the Comptroller General of the United States . . .."

.02 Unqualified Opinion on General Purpose or Component Unit Financial Statements Submitted Together With Combining, Individual Fund and Account Group Financial Statements and Supporting Schedules as Supplementary Data[1]

Independent Auditor's Report

Addressee:

We have audited the accompanying general purpose* financial statements of City of Example, Any State as of December 31, 19XX, and for the year then ended as listed in the table of contents. These general purpose financial statements are the responsibility of City of Example, Any State management. Our responsibility is to express an opinion on these general purpose 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 general purpose financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the general purpose financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall general purpose financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the general purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State as of December 31, 19XX, and the results of its operations and cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.

Our audit was made for the purpose of forming an opinion on the general purpose financial statements taken as a whole. The combining and individual fund and account group financial statements and schedules listed in the table of contents are presented for purposes of additional analysis and are not a required part of the general purpose financial statements of the City of Example, Any State. Such information has been subjected to the auditing procedures applied in the audit of the general purpose financial statements and, in our opinion, is fairly presented in all material respects in relation to the general purpose financial statements taken as a whole.

[*Signature*]

[*Date*]

[Source: SOP 92-7, *Audits of State and Local Governmental Entities Receiving Federal Financial Assistance.*]

[1] If a schedule of federal financial assistance is reported on as supplementary data, *Government Auditing Standards,* issued by the Comptroller General of the United States, should be referenced in the second paragraph. See AAM section 10,700.17 for guidance on issuing a separate report on a schedule of federal financial assistance.

* If the financial statements are for a component unit, the term "general purpose financial statements" should not be used. In the case of a component unit, the term "component unit financial statements" or just "financial statements" should be used. For the component unit financial statements of an oversight unit, the principles of AAM section 10,700.04 should be combined with those of this section.

.03 Unqualified Opinion on General Purpose or Component Unit Financial Statements and Combining and Individual Fund and Account Group Financial Statements Presented Together With Supporting Schedules Reported on as Supplementary Data

Independent Auditor's Report

Addressee:

We have audited the accompanying general purpose* financial statements and the combining and individual fund and account group financial statements of City of Example, Any State, as of December 31, 19XX, and for the year then ended as listed in the table of contents. These financial statements are the responsibility of City of Example, Any State 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 general purpose financial statements referred to above present fairly, in all material respects, the financial position of the City of Example, Any State, as of December 31, 19XX, and the results of its operations and cash flows of its proprietary and similar trust fund types for the year then ended, in conformity with generally accepted accounting principles. Also, in our opinion, the combining and individual fund and account group financial statements referred to above present fairly, in all material respects, the financial position of each of the individual funds and account groups of the City of Example, Any State, as of December 31, 19XX, and the results of operations of such funds and its cash flows of the individual proprietary fund types and nonexpendable trust funds for the year then ended, in conformity with generally accepted accounting principles.

Our audit was made for the purpose of forming an opinion on the general purpose financial statements taken as a whole and on the combining and individual fund and account group financial statements. The accompanying financial information listed as supporting schedules in the table of contents is presented for purposes of additional analysis and is not a required part of the financial statements of the City of Example, Any State. Such information has been subjected to the auditing procedures applied in the audit of the general purpose, combining and individual fund and account group financial statements and, in our opinion, is fairly presented in all material respects in relation to the financial statements of each of the respective individual funds and account groups, taken as a whole.

[*Signature*]

[*Date*]

[Source: SOP 92-7, *Audits of State and Local Governmental Entities Receiving Federal Financial Assistance.*]

* If the financial statements are for a component unit, the term "general purpose financial statements" should not be used. In the case of a component unit, the term "component unit financial statements" or just "financial statements" should be used. For the component unit financial statements of an oversight unit, the principles of AAM section 10,700.04 should be combined with those of this section.

.04 Unqualified Opinion on Component Unit Financial Statements of an Oversight Unit That Omit the Financial Statements of All Other Component Units *

<u>Independent Auditor's Report</u>

Addressee:

We have audited the accompanying component unit financial statements of City of Example, Any State oversight unit, as of December 31, 19XX, and for the year then ended. These component unit financial statements are the responsibility of City of Example, Any State, oversight unit is management. Our responsibility is to express an opinion on these component unit 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 component unit financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the component unit financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall component unit financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The component unit financial statements referred to above include only the financial activities of the oversight unit. Financial activities of other component units that form the reporting entity are not included.

In our opinion, the component unit financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State, oversight unit, as of December 31, 19XX, and the results of its operations and cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SOP 92-7, *Audits of State and Local Governmental Entities Receiving Federal Financial Assistance.*]

* After GASB Statement No. 14, *The Financial Reporting Entity,* is adopted or becomes effective, financial statements that present only the data of the primary government should acknowledge that the financial statements do not include the data of the component units necessary for reporting in conformity with generally accepted accounting principles.

.05 Qualified Opinion on General Purpose Financial Statements That Omit One or More, but Not All, Component Units of the Reporting Entity

Independent Auditor's Report

Addressee:

We have audited the accompanying general purpose* financial statements of City of Example, Any State as of December 31, 19XX, and for the year then ended. These general purpose financial statements are the responsibility of City of Example, Any State 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 general purpose financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the general purpose financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall general purpose financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The general purpose financial statements referred to above do not include financial activities of the [*identify the component unit omitted*], which should be included in order to conform with generally accepted accounting principles. If the omitted component unit had been included,** the assets and revenues of the [*identify fund type(s), e.g., special revenue fund type*] would have increased by $XXX,XXX and $XXX,XXX, respectively, there would have been an excess of expenditures over revenues in that fund type for the year of $XXX,XXX, and the [*identify fund type(s)*] fund balance would have been a deficit of $XXX,XXX.

In our opinion, except for the effects on the financial statements of the omission described in the preceding paragraph, the general purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State as of December 31, 19XX, and the results of its operations and cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SOP 92-7, *Audits of State and Local Governmental Entities Receiving Federal Financial Assistance.*]

NOTE:

If the omission was sufficiently material, the auditor should express an adverse opinion on the general purpose financial statements. In such case, a separate explanatory paragraph should state all the substantive reasons for the adverse opinion and the principal effects of those matters. See AAM section 10,700.06 for reporting guidance.

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* If the financial statements are for a component unit, the term "general purpose financial statements" should not be used. In the case of a component unit, the term "component unit financial statements" or just "financial statements" should be used. For the component unit financial statements of an oversight unit, the principles of AAM section 10,700.04 should be combined with those of this section.

** If the amounts applicable to the omitted component have not been audited, insert the phrase "based on unaudited information."

.06 Adverse Opinion on General Purpose Financial Statements That Omit One or More, But Not All, Component Units of the Reporting Entity

Independent Auditor's Report

Addressee:

We have audited the accompanying general purpose* financial statements of City of Example, Any State as of December 31, 19XX, and for the year then ended. These general purpose financial statements are the responsibility of City of Example, Any State management. Our responsibility is to express an opinion on these general purpose 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 general purpose financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the general purpose financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall general purpose financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The general purpose financial statements referred to above do not include financial activities of the [*identify the component unit omitted*], which should be included in order to conform with generally accepted accounting principles.

Because of the departure from generally accepted accounting principles identified above, as of December 31, 19XX, the assets and revenues of the [*identify fund type(s), e.g., special revenue fund type*] would have increased by $XXX,XXX and $XXX,XXX, respectively, there would have been an excess of expenditures over revenues in that fund type for the year of $XXX,XXX, and the [*identify fund type(s)*] fund balance would have been a deficit of $XXX,XXX.

In our opinion, because of the effects of the matters discussed in the preceding paragraphs the general purpose financial statements referred to above do not present fairly, in conformity with generally accepted accounting principles, the financial position of City of Example, Any State as of December 31, 19XX, or the results of operations or cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended.

[*Signature*]

[*Date*]

[Source: SOP 92-7, *Audits of State and Local Governmental Entities Receiving Federal Financial Assistance.*]

* If the financial statements are for a component unit, the term "general purpose financial statements" should not be used. In the case of a component unit, the term "component unit financial statements" or just "financial statements" should be used. For the component unit financial statements of an oversight unit, the principles of AAM section 10,700.04 should be combined with those of this section.

.07 Qualified Opinion on General Purpose or Component Unit Financial Statements That Omit a Fund Type or Account Group

Independent Auditor's Report

Addressee:

We have audited the accompanying general purpose* financial statements of City of Example, Any State as of December 31, 19XX, and for the year then ended. These general purpose financial statements are the responsibility of City of Example, Any State management. Our responsibility is to express an opinion on these general purpose 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 general purpose financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the general purpose financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall general purpose financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The general purpose financial statements referred to above do not include the [*identify the fund type (account group) omitted*], which should be included to conform with generally accepted accounting principles. The omitted fund type** has assets, liabilities, revenues, and expenditures of $XXX,XXX, $XXX,XXX, $XXX,XXX, and $XXX,XXX, respectively. (The amount that should be recorded in the general fixed assets account group is not known.)

In our opinion, except for the effect on the general purpose* financial statements of the omission described in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State as of December 31, 19XX, and the results of its operations and cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended, in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SOP 92-7, *Audits of State and Local Governmental Entities Receiving Federal Financial Assistance.*]

NOTE:

If the omission was sufficiently material, the auditor should express an adverse opinion on the financial statements. In such case, a separate explanatory paragraph should state all the substantive reasons for the adverse opinion and the principal effects of those matters. See AAM section 10,700.06 for guidance.

* If the financial statements are for a component unit, the term "general purpose financial statements" should not be used. In the case of a component unit, the term "component unit financial statements" or just "financial statements" should be used. For the component unit financial statements of an oversight unit, the principles of AAM section 10,700.04 should be combined with this section.

** If the amounts applicable to the omitted fund type have not been audited, insert the phrase "based on unaudited information."

.08 Qualified Opinion on General Purpose or Component Unit Financial Statements That Omit a Fund From a Fund Type

Independent Auditor's Report

Addressee:

We have audited the accompanying general purpose* financial statements of City of Example, Any State as of December 31, 19XX, and for the year then ended. These general purpose financial statements are the responsibility of City of Example, Any State, management. Our responsibility is to express an opinion on these general purpose 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 general purpose financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the general purpose financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall general purpose financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The general purpose financial statements referred to above do not include the [*identify the omitted fund*], which should be included to conform with generally accepted accounting principles. If the omitted fund** had been included, the [*identify fund type*] assets, liabilities, revenues, and expenditures would have increased $XXX,XXX, $XXX,XXX, $XXX,XXX, and $XXX,XXX, respectively.

In our opinion, except for the effect on the general purpose financial statements of the omission described in the preceding paragraph, the general purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State as of December 31, 19XX, and the results of its operations and cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended, in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SOP 92-7, *Audits of State and Local Governmental Entities Receiving Federal Financial Assistance.*]

NOTE:

If the omission was sufficiently material, the auditor should express an adverse opinion on the financial statements. In such case, a separate explanatory paragraph should state all the substantive reasons for the adverse opinion and the principal effects of those matters. See AAM section 10,700.06 for guidance.

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* If the financial statements are for a component unit, the term "general purpose financial statements" should not be used. In the case of a component unit, the term "component unit financial statements" or just "financial statements" should be used. For the component unit financial statements of an oversight unit, the principles of AAM section 10,700.04 should be combined with this section.

** If the amounts applicable to the omitted fund have not been audited, insert the phrase "based on unaudited information."

.09 Unqualified Opinion on General Fund Financial Statements With an Explanatory Paragraph Calling Attention to the Fact That the Financial Statements Do Not Represent the Financial Position and Results of Operations of the Governmental Unit *

Independent Auditor's Report

Addressee:

We have audited the accompanying financial statements of the general fund of the City of Example, Any State as of December 31, 19XX, and for the year then ended. These financial statements are the responsibility of City of Example, Any State, 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.

As discussed in Note __, the financial statements present only the general fund and are not intended to present fairly the financial position and results of operations of City of Example, Any State, in conformity with generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the general fund of City of Example, Any State as of December 31, 19XX, and the results of its operations for the year then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SOP 92-7, *Audits of State and Local Governmental Entities Receiving Federal Financial Assistance.*]

* After GASB Statement No. 14, *The Financial Reporting Entity,* is adopted or becomes effective, financial statements that present only the data of the primary government should acknowledge that the financial statements do not include the data of the component units necessary for reporting in conformity with generally accepted accounting principles.

.10 Unqualified Opinion on an Enterprise Fund's Financial Statements With an Explanatory Paragraph Calling Attention to the Fact That the Financial Statements Do Not Represent the Financial Position and Results of Operations of the Governmental Unit

Independent Auditor's Report

Addressee:

We have audited the accompanying financial statements of the [*identify enterprise fund*] of the City of Example, Any State as of December 31, 19XX, and for the year then ended. These financial statements are the responsibility of City of Example, Any State 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.

As discussed in Note __, the financial statements present only the [*identify enterprise fund*] and are not intended to present fairly the financial position of City of Example, Any State and the results of operations and cash flows of its proprietary fund types and nonexpendable trust funds in conformity with generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the [*identify enterprise fund*] of the City of Example, Any State as of December 31, 19XX, and the results of its operations and cash flows for the year then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SOP 92-7, *Audits of State and Local Governmental Entities Receiving Federal Financial Assistance.*]

.11 Unqualified Opinion on General Purpose or Component Unit Financial Statements With an Explanatory Paragraph Calling Attention to Substantial Doubt About the Ability of a Governmental Unit to Meet Its Debts as They Come Due[1]

Independent Auditor's Report

Addressee:

We have audited the accompanying general purpose* financial statements of City of Example, Any State as of December 31, 19XX, and for the year then ended. These general purpose financial statements are the responsibility of City of Example, Any State, management. Our responsibility is to express an opinion on these general purpose 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 general purpose financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the general purpose financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall general purpose financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the general purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State as of December 31, 19XX, and the results of its operations and cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.

As discussed in Note __, [*include description of reason that a question has arisen about the ability of the governmental unit to meet its debts as they come due*]. The general purpose financial statements do not include any adjustment relating to the amounts and classification of liabilities that might be necessary if City of Example, Any State, is not able to meet its debts as they come due or if such debts are adjusted under the provisions of chapter 9 of the Federal Bankruptcy Code.

[*Signature*]

[*Date*]

[Source: SOP 92-7, *Audits of State and Local Governmental Entities Receiving Federal Financial Assistance.*]

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[1] See criteria in SAS No. 58, *Reports on Audited Financial Statements*, paragraphs 24 through 30 [AU section 508.24 through .30], regarding uncertainties and see discussion of reporting considerations when the auditor has substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time in SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, paragraphs 12 through 16 [AU section 341.12 through .16].

* If the financial statements are for a component unit, the term "general purpose financial statements" should not be used. In the case of a component unit, the term "component unit financial statements" or just "financial statements" should be used. For the component unit financial statements of an oversight unit, the principles of AAM section 10,700.04 should be combined with this section.

.12 Qualified Opinion on General Purpose Financial Statements That Include an Unaudited Organization, Function, or Activity

Independent Auditor's Report

Addressee:

We have audited the accompanying general purpose* financial statements of City of Example, Any State as of December 31, 19XX, and for the year then ended. These general purpose financial statements are the responsibility of City of Example, Any State, management. Our responsibility is to express an opinion on these general purpose financial statements based on our audit.

Except as discussed in the following paragraph, 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 general purpose financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the general purpose financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall general purpose financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

We were unable to obtain audited financial statements supporting the financial activities of the [*identify the organization, function, or activity*] because [*state reasons why audited information could not be obtained*]. Those financial activities are included in the [*identify fund type or account group*] and represent XX percent and XX percent of the assets and revenues, respectively, of that fund type.

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 audit the financial statements of [*identify the organization, function, or activity*] the general purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State as of December 31, 19XX, and the results of its operations and cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended, in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SOP 92-7, *Audits of State and Local Governmental Entities Receiving Federal Financial Assistance.*]

* If the financial statements are for a component unit, the term "general purpose financial statements" should not be used. In the case of a component unit, the term "component unit financial statements" or just "financial statements" should be used. For the component unit financial statements of an oversight unit, the principles of AAM section 10,700.04 should be combined with those of this section.

.13 Unqualified Opinion on General Purpose Financial Statements With Reference to Audit of Part of a Fund Type by Other Auditors

Independent Auditor's Report

Addressee:

We have audited the accompanying general purpose* financial statements of City of Example, Any State, as of December 31, 19XX, and for the year then ended. These general purpose financial statements are the responsibility of City of Example, Any State, management. Our responsibility is to express an opinion on these general purpose financial statements based on our audit. We did not audit the financial statements of [*identify component unit or fund*], which represent XX percent and XX percent, respectively, of the assets and revenues of the [*identify fund type*]. Those financial statements were audited by other auditors whose report thereon has been furnished to us and our opinion, insofar as it relates to the amounts included for [*identify component unit or fund*], is based solely upon the report of the other auditors.

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 general purpose financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the general purpose financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall general purpose financial statement presentation. We believe that our audit and the report of other auditors provide a reasonable basis for our opinion.

In our opinion, based upon our audit and the report of other auditors, the general purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State as of December 31, 19XX, and the results of its operations and cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended, in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SOP 92-7, *Audits of State and Local Governmental Entities Receiving Federal Financial Assistance.*]

* If the financial statements are for a component unit, the term "general purpose financial statements" should not be used. In the case of a component unit, the term "component unit financial statements" or just "financial statements" should be used. For the component unit financial statements of an oversight unit, the principles of AAM section 10,700.04 should be combined with those of this section.

.14 Unqualified Opinion on General Purpose Financial Statements With Reference to Audit of All of a Fund Type by Another Auditor

Independent Auditor's Report

Addressee:

We have audited the accompanying general purpose* financial statements of City of Example, Any State as of December 31, 19XX, and for the year then ended. These general purpose financial statements are the responsibility of City of Example, Any State management. Our responsibility is to express an opinion on these general purpose financial statements based on our audit. We did not audit the financial statements of [*identify fund type*]. Those financial statements were audited by other auditors whose report thereon has been furnished to us, and our opinion, insofar as it relates to the amounts included for [*identify fund type*], is based solely upon the report of the other auditors.

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 general purpose financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the general purpose financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall general purpose financial statement presentation. We believe that our audit and the report of other auditors provide a reasonable basis for our opinion.

In our opinion, based upon our audit and the report of other auditors, the general purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State, as of December 31, 19XX, and the results of its operations and cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended, in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SOP 92-7, *Audits of State and Local Governmental Entities Receiving Federal Financial Assistance.*]

* If the financial statements are for a component unit, the term "general purpose financial statements" should not be used. In the case of a component unit, the term "component unit financial statements" or just "financial statements" should be used. For the component unit financial statements of an oversight unit, the principles of AAM section 10,700.04 should be combined with those of this section.

.15 Report on Financial Statements Prepared in Accordance With a Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles

Independent Auditor's Report

Addressee:

We have audited the financial statements of City of Example, Any State as of and for the year ended June 30, 19XX, as listed in the table of contents. These financial statements are the responsibility of the City of Example, Any State, 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.

As discussed in Note ______, City of Example, Any State, prepares its financial statements on a prescribed basis of accounting that demonstrates compliance with the cash basis and budget laws of Any State, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the cash and unencumbered cash balances of City of Example, Any State, at June 30, 19XX, and the revenues it received and expenditures it paid for the year then ended on the basis of accounting described in Note ______.

[*Signature*]

[*Date*]

[Source: SOP 92-7, *Audits of State and Local Governmental Entities Receiving Federal Financial Assistance.*]

.16 Unqualified Opinion on a Financial Statement of a Department Constituting Less Than a Fund

Independent Auditor's Report

Addressee:

We have audited the accompanying financial statements of Department of Example, Any State, as of June 30, 19XX, and for the year then ended. These financial statements are the responsibility of Department of Example, Any State, 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.

As discussed in Note ______, the financial statements of Department of Example, Any State are intended to present the financial position and results of operations and cash flows of proprietary fund types of only that portion of the funds and account groups of the State that is attributable to the transactions of the Department.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Department of Example, Any State at June 30, 19XX, and the results of its operations and cash flows for the year then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SOP 92-7, *Audits of State and Local Governmental Entities Receiving Federal Financial Assistance.*]

.17 Report on Supplementary Schedule of Federal Financial Assistance

Independent Auditor's Report

Addressee:

We have audited the general purpose * financial statements of City of Example, Any State, for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.** These general purpose financial statements are the responsibility of City of Example, Any State, management. Our responsibility is to express an opinion on these general purpose financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards,* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the general purpose financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the general purpose 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.

Our audit was made for the purpose of forming an opinion on the general purpose financial statements of City of Example, Any State, taken as a whole. The accompanying schedule of federal financial assistance is presented for purposes of additional analysis and is not a required part of the general purpose financial statements. The information in that schedule has been subjected to the auditing procedures applied in the audit of the general purpose financial statements and, in our opinion, is fairly presented in all material respects in relation to the general purpose financial statements taken as a whole.

[*Signature*]

[*Date*]

[Source: SOP 92-7, *Audits of State and Local Governmental Entities Receiving Federal Financial Assistance.*]

* If the financial statements are for a component unit, the term "general purpose financial statements" should not be used. In the case of a component unit, the term "component unit financial statements" or just "financial statements" should be used. For the component unit financial statements of an oversight unit, the principles of AAM section 10,700.04 should be combined with those of this section.

** Describe any departure from the standard report.

.18 Compliance Report Based on an Audit of General Purpose or Basic Financial Statements Performed in Accordance With *Government Auditing Standards*

Independent Auditor's Report

Addressee:

We have audited the general purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.*

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards,* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the general purpose financial statements are free of material misstatement.

Compliance with laws, regulations, contracts, and grants applicable to City of Example, Any State, is the responsibility of City of Example, Any State's management. As part of obtaining reasonable assurance about whether the general purpose financial statements are free of material misstatement, we performed tests of the City of Example, Any State's compliance with certain provisions of laws, regulations, contracts, and grants. However, the objective of our audit of the general purpose financial statements was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

The results of our tests indicate that, with respect to the items tested, City of Example, Any State, complied, in all material respects, with the provisions referred to in the preceding paragraph. With respect to items not tested, nothing came to our attention that caused us to believe that the City of Example, Any State, had not complied, in all material respects, with those provisions.**

This report is intended for the information of the audit committee, management and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.

[*Signature*]

[*Date*]

[Source: SOP 92-7, *Audits of State and Local Governmental Entities Receiving Federal Financial Assistance.*]

* Describe any departure from the standard report.

** If it is determined that noncompliance is pervasive or negative assurance cannot be provided, the principles in AAM section 10,700.19 should be followed.

.19 Compliance Report Based on an Audit of General Purpose or Basic Financial Statements Performed in Accordance With *Government Auditing Standards*—Negative Assurance Not Provided

Independent Auditor's Report

Addressee:

We have audited the general purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.*

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards,* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the general purpose financial statements are free of material misstatement.

Compliance with laws, regulations, contracts, and grants applicable to City of Example, Any State, is the responsibility of City of Example, Any State's management. As part of obtaining reasonable assurance about whether the general purpose financial statements are free of material misstatement, we performed tests of the City of Example, Any State's compliance with certain provisions of laws, regulations, contracts, and grants. However, the objective of our audit of the general purpose financial statements was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

The results of our tests indicate that, with respect to the items tested, City of Example, Any State, complied with those laws and regulations referred to above, except as described in the attached schedule. However, the extent of noncompliance noted in our testing indicates that, with respect to items that were not tested by us, there is more than a relatively low risk that City of Example, Any State, may not have complied with the provisions referred to in the preceding paragraph. These matters were considered by us in evaluating whether the general purpose financial statements are presented fairly in conformity with generally accepted accounting principles.

This report is intended for the information of the audit committee, management and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.

[*Signature*]

[*Date*]

[*Source:* SOP 92-7, *Audits of State and Local Governmental Entities Receiving Federal Financial Assistance.*]

* Describe any departure from the standard report.

.20 Compliance Report Based on an Audit of General Purpose or Basic Financial Statements Performed in Accordance With *Government Auditing Standards* When Uncertainty About Noncompliance Exists

Independent Auditor's Report

Addressee:

We have audited the general purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.*

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards,* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the general purpose financial statements are free of material misstatement.

Compliance with laws, regulations, contracts, and grants applicable to City of Example, Any State, is the responsibility of City of Example, Any State management. As part of obtaining reasonable assurance about whether the general purpose financial statements are free of material misstatement, we performed tests of the City of Example, Any State's compliance with certain provisions of laws and regulations, contracts, and grants. However, the objective of our audit of the general purpose financial statements was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

Material instances of noncompliance consist of failures to follow requirements, or violations of prohibitions, contained in statutes, regulations, contracts or grants that cause us to conclude that the aggregation of the misstatements resulting from those failures or violations is material to the general purpose financial statements. The results of our tests of compliance disclosed the following instances of noncompliance described in the attached ______, that may be material to the general purpose financial statements but for which the ultimate resolution cannot presently be determined. Accordingly, no provision for any liability that may result has been recognized in City of Example, Any State's 19X1 financial statements.

[*Include paragraphs describing the material instances of noncompliance noted.*]

We considered these instances of noncompliance in forming our opinion on whether the 19X1 general purpose financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, and this report does not affect our report dated August 15, 19X1 on those general purpose financial statements.

Except as described above, the results of our tests of compliance indicate that, with respect to the items tested, City of Example, Any State, complied, in all material respects, with the provisions referred to in the third paragraph of this report; and with respect to items not tested, nothing came to our attention that caused us to believe that City of Example, Any State, had not complied, in all material respects, with those provisions.

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* Describe any departure from the standard report.

This report is intended for the information of the audit committee, management and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.

[*Signature*]

[*Date*]

[Source: SOP 92-7, *Audits of State and Local Governmental Entities Receiving Federal Financial Assistance.*]

.21 Single Audit Opinion on Compliance With Specific Requirements Applicable to Major Federal Financial Assistance Programs

Independent Auditor's Opinion

Addressee:

We have audited the general purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.[1]

We have also audited City of Example, Any State's compliance with the requirements governing [*list specific requirements tested*] that are applicable to each of its major federal financial assistance programs, which are identified in the accompanying schedule of federal financial assistance,[2] for the year ended June 30, 19X1. The management of City of Example, Any State, is responsible for City of Example, Any State's compliance with those requirements. Our responsibility is to express an opinion on compliance with those requirements based on our audit.

We conducted our audit of compliance with those requirements in accordance with generally accepted auditing standards; *Government Auditing Standards,* issued by the Comptroller General of the United States; and OMB Circular A-128, *Audits of State and Local Governments.* Those standards and OMB Circular A-128 require that we plan and perform the audit to obtain reasonable assurance about whether material noncompliance with the requirements referred to above occurred. An audit includes examining, on a test basis, evidence about City of Example, Any State's compliance with those requirements. We believe that our audit provides a reasonable basis for our opinion.

The results of our audit procedures disclosed immaterial instances of noncompliance with the requirements referred to above, which are described in the accompanying Schedule of Findings and Questioned Costs. We considered these instances of noncompliance in forming our opinion on compliance, which is expressed in the following paragraph.[3]

In our opinion, City of Example, Any State, complied, in all material respects, with the requirements governing [*list requirements tested*] that are applicable to each of its major federal financial assistance programs for the year ended June 30, 19X1.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.

[*Signature*]

[*Date*]

[Source: SOP 92-7, *Audits of State and Local Governmental Entities Receiving Federal Financial Assistance.*]

[1] Describe any departure from the standard report.

[2] Major programs need to be clearly identified in the Supplementary Schedule of Federal Financial Assistance.

[3] When there are no instances of noncompliance, this paragraph should be deleted.

.22 Single Audit Opinion on Compliance With Specific Requirements Applicable to Major Federal Financial Assistance Programs—Qualified Because of a Scope Limitation

Independent Auditor's Opinion

Addressee:

We have audited the general purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.*

We have also audited City of Example, Any State's compliance with the requirements governing [*list specific requirements tested*] that are applicable to each of its major federal financial assistance programs, which are identified in the accompanying Schedule of Federal Financial Assistance, for the year ended June 30, 19X1. The management of City of Example, Any State, is responsible for City of Example, Any State's compliance with those requirements. Our responsibility is to express an opinion on compliance with those requirements based on our audit.

Except as discussed in the following paragraph, we conducted our audit of compliance with those requirements in accordance with generally accepted auditing standards; *Government Auditing Standards* issued by the Comptroller General of the United States; and OMB Circular A-128, *Audits of State and Local Governments*. Those standards and OMB Circular A-128 require that we plan and perform the audit to obtain reasonable assurance about whether material noncompliance with the requirements referred to above occurred. An audit includes examining, on a test basis, evidence about City of Example, Any State's compliance with those requirements. We believe that our audit provides a reasonable basis for our opinion.

We were unable to obtain sufficient documentation supporting City of Example, Any State's compliance with the requirements of Major Program ABC governing types of services allowed or unallowed; nor were we able to satisfy ourselves as to City of Example, Any State's compliance with those requirements of Major Program ABC by other auditing procedures.

In addition, the results of our audit procedures disclosed immaterial instances of noncompliance with the requirements referred to above, which are described in the accompanying Schedule of Findings and Questioned Costs. We considered these instances of noncompliance in forming our opinion on compliance, which is expressed in the following paragraph.

In our opinion, except for the effects of such noncompliance, if any, as might have been determined had we been able to examine sufficient evidence regarding City of Example, Any State's compliance with the requirements of Major Program ABC governing types of services allowed or unallowed, City of Example, Any State, complied, in all material respects, with the requirements governing [*list requirements tested*] that are applicable to each of its major federal financial assistance programs for the year ended June 30, 19X1.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.

[*Signature*]

[*Date*]

[Source: SOP 92-7, *Audits of State and Local Governmental Entities Receiving Federal Financial Assistance.*]

* Describe any departure from the standard report.

.23 Single Audit Disclaimer of Opinion on Compliance With Specific Requirements Applicable to Major Federal Financial Assistance Programs—Scope Limitation

Independent Auditor's Report

Addressee:

We have audited the general purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.*

We were also engaged to audit City of Example, Any State's compliance with the requirements governing [*list requirements to have been tested*] that are applicable to each of its major federal financial assistance programs, which are identified in the accompanying Schedule of Federal Financial Assistance, for the year ended June 30, 19X1. The management of City of Example, Any State, is responsible for City of Example, Any State's compliance with those requirements.

The management of City of Example, Any State, has refused to provide us with written representations that generally accepted auditing standards require us to obtain.

Because of the matter described in the preceding paragraph, the scope of our audit work was not sufficient to enable us to express, and we do not express, an opinion on City of Example, Any State's compliance with the requirements governing [*list requirements to have been tested*] that are applicable to each of its major federal financial assistance programs for the year ended June 30, 19X1.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.

[*Signature*]

[*Date*]

[Source: SOP 92-7, *Audits of State and Local Governmental Entities Receiving Federal Financial Assistance.*]

* Describe any departure from the standard report.

.24 Single Audit Opinion on Compliance With Specific Requirements Applicable to Major Federal Financial Assistance Programs—Qualified Because of Noncompliance

Independent Auditor's Opinion

Addressee:

We have audited the general purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.*

We have also audited City of Example, Any State's compliance with the requirements governing [*list requirements tested*] that are applicable to each of its major federal financial assistance programs, which are identified in the accompanying Schedule of Federal Financial Assistance, for the year ended June 30, 19X1. The management of City of Example, Any State is responsible for City of Example, Any State's compliance with those requirements. Our responsibility is to express an opinion on compliance with those requirements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards; *Government Auditing Standards,* issued by the Comptroller General of the United States; and OMB Circular A-128, *Audits of State and Local Governments.* Those standards and OMB Circular A-128 require that we plan and perform the audit to obtain reasonable assurance about whether material noncompliance with the requirements referred to above occurred. An audit includes examining, on a test basis, evidence about City of Example, Any State's compliance with those requirements. We believe that our audit provides a reasonable basis for our opinion.

The results of our audit procedures for Major Program ABC disclosed that City of Example, Any State, did not comply with the requirement that City match the funds received from Major Program ABC. In our opinion, City of Example, Any State's matching of funds received from Major Program ABC is necessary for City of Example, Any State to comply with the requirements applicable to Major Program ABC.

In addition, the results of our audit procedures disclosed immaterial instances of noncompliance with the requirements referred to in the third paragraph, which are described in the accompanying Schedule of Findings and Questioned Costs. We considered these instances of noncompliance in forming our opinion on compliance, which is expressed in the following paragraph.

In our opinion, except for those instances of noncompliance with the requirements applicable to Major Program ABC referred to in the fourth paragraph of this report and identified in the accompanying Schedule of Findings and Questioned Costs, City of Example, Any State, complied, in all material respects, with the requirements governing [*list requirements tested*] that are applicable to each of its major federal financial assistance programs for the year ended June 30, 19X1.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.

[*Signature*]

[*Date*]

[Source: SOP 92-7, *Audits of State and Local Governmental Entities Receiving Federal Financial Assistance.*]

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* Describe any departure from the standard report.

.25 Single Audit Adverse Opinion on Compliance With Specific Requirements Applicable to Major Federal Financial Assistance Programs

Independent Auditor's Opinion

Addressee:

We have audited the general purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.*

We have also audited City of Example, Any State's compliance with the requirements governing [*list requirements tested*] that are applicable to each of its major federal financial assistance programs, which are identified in the accompanying Schedule of Federal Financial Assistance, for the year ended June 30, 19X1. The management of City of Example, Any State is responsible for City of Example, Any State's compliance with those requirements. Our responsibility is to express an opinion on compliance with those requirements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards; *Government Auditing Standards,* issued by the Comptroller General of the United States; and OMB Circular A-128, *Audits of State and Local Governments.* Those standards and OMB Circular A-128 require that we plan and perform the audit to obtain reasonable assurance about whether material noncompliance with the requirements referred to above occurred. An audit includes examining, on a test basis, evidence about City of Example, Any State's compliance with those requirements. We believe that our audit provides a reasonable basis for our opinion.

[*Add a paragraph describing reasons for the adverse opinion.*]

In addition, the results of our audit procedures disclosed immaterial instances of noncompliance with the requirements referred to above, which are described in the accompanying Schedule of Findings and Questioned Costs. We considered these instances of noncompliance in forming our opinion on compliance, which is expressed in the following paragraph.

In our opinion, because of those instances of noncompliance referred to in the fourth paragraph, City of Example, Any State, did not comply, in all material respects, with the requirements governing [*list requirements tested*] that are applicable to each of its major federal financial assistance programs for the year ended June 30, 19X1.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.

[*Signature*]

[*Date*]

[Source: SOP 92-7, *Audits of State and Local Governmental Entities Receiving Financial Assistance.*]

* Describe any departure from the standard report.

.26 Single Audit Report on Compliance With the General Requirements Applicable to Federal Financial Assistance Programs

Independent Auditor's Report

Addressee:

We have audited the general purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.*

We have applied procedures to test City of Example, Any State's compliance with the following requirements applicable to its federal financial assistance programs, which are identified in the Schedule of Federal Financial Assistance, for the year ended June 30, 19X1 [*list the general requirements tested*].

Our procedures were limited to the applicable procedures described in the Office of Management and Budget's *Compliance Supplement for Single Audits of State and Local Governments* [*or describe alternative procedures performed*]. Our procedures were substantially less in scope than the audit, the objective of which is the expression of an opinion on City of Example, Any State's compliance with the requirements listed in the preceding paragraph. Accordingly, we do not express such an opinion.

With respect to the items tested, the results of those procedures disclosed no material instances of noncompliance with the requirements listed in the second paragraph of this report. With respect to items not tested, nothing came to our attention that caused us to believe that City of Example, Any State, had not complied, in all material respects, with those requirements. However, the results of our procedures disclosed immaterial instances of noncompliance with those requirements, which are described in the accompanying Schedule of Findings and Questioned Costs.**

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.

[*Signature*]

[*Date*]

[Source: SOP 92-7, *Audits of State and Local Governmental Entities Receiving Federal Financial Assistance.*]

* Describe any departure from the standard report.

** When there are no immaterial instances of noncompliance, this sentence should be deleted.

.27 Single Audit Report on Compliance With Specific Requirements Applicable to Nonmajor Federal Financial Assistance Program Transactions

Independent Auditor's Report

Addressee:

We have audited the general purpose financial statements of City of Example, Any State as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.

In connection with our audit of the financial statements of City of Example, Any State, and with our consideration of City of Example, Any State's control structure used to administer federal financial assistance programs, as required by Office of Management and Budget Circular A-128, *Audits of State and Local Governments,* we selected certain transactions applicable to certain nonmajor federal financial assistance programs for the year ended June 30, 19X1. As required by Circular A-128, we have performed auditing procedures to test compliance with the requirements governing [*list requirements tested*] that are applicable to those transactions. Our procedures were substantially less in scope than an audit, the objective of which is the expression of an opinion on City of Example, Any State's compliance with these requirements. Accordingly, we do not express such an opinion.

With respect to the items tested, the results of those procedures disclosed no material instances of noncompliance with the requirements listed in the preceding paragraph. With respect to items not tested, nothing came to our attention that caused us to believe that City of Example, Any State, had not complied, in all material respects, with those requirements. However, the results of our procedures disclosed immaterial instances of noncompliance with those requirements, which are described in the accompanying Schedule of Findings and Questioned Costs.*

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.

[*Signature*]

[*Date*]

[Source: SOP 92-7, *Audits of State and Local Governmental Entities Receiving Federal Financial Assistance.*]

* If there are no instances of noncompliance, this sentence should be deleted.

.28 Report on the Internal Control Structure Based on Audit of General Purpose or Basic Financial Statements Performed in Accordance with *Government Auditing Standards*

Independent Auditor's Report

Addressee:

We have audited the general purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.[1]

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards,* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the general purpose financial statements are free of material misstatement.

In planning and performing our audit of the general purpose financial statements of City of Example, Any State, for the year ended June 30, 19XX, we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the general purpose financial statements and not to provide assurance on the internal control structure.

The management of City of Example, Any State is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of general purpose financial statements in accordance with generally accepted accounting principles.[2] Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

For the purpose of this report, we have classified the significant internal control structure policies and procedures in the following categories [*identify internal control structure categories*].

For all of the internal control structure categories listed above, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operations, and we assessed control risk.

We noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the entity's ability to record, process, summarize, and report financial data consistent with the assertions of management in the general purpose financial statements.[3]

[*Include paragraphs to describe the reportable conditions noted.*]

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[1] Describe any departure from the standard report.

[2] If the financial statements are on a basis other than GAAP, the report should be modified.

[3] SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit,* paragraph 17 [AU section 325.17], prohibits the auditor from issuing a written report representing that no reportable conditions were noted during an audit. When the auditor notes no reportable conditions during an audit, he may issue a report shown in AAM section 10,700.29 to satisfy the requirements of *Government Auditing Standards.*

A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the general purpose financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe none of the reportable conditions described above is a material weakness.

We also noted other matters involving the internal control structure and its operation that we have reported to the management of City of Example, Any State, in a separate letter dated August 15, 19XX.*

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.

[*Signature*]

[*Date*]

[Source: SOP 92-7, *Audits of State and Local Governmental Entities Receiving Federal Financial Assistance.*]

* If a separate letter has not been issued, this paragraph should be omitted.

.29 Report on Internal Control Structure Based on an Audit of General Purpose or Basic Financial Statements Performed in Accordance With *Government Auditing Standards*—No Material Weaknesses When There Are No Reportable Conditions

Independent Auditor's Report

Addressee:

We have audited the general purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.[1]

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards,* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the general purpose financial statements are free of material misstatement.

In planning and performing our audit of the general purpose financial statements of City of Example, Any State, for the year ended June 30, 19XX, we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the general purpose financial statements and not to provide assurance on the internal control structure.

The management of City of Example, Any State, is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of general purpose financial statements in accordance with generally accepted accounting principles.[2] Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

For the purpose of this report, we have classified the significant internal control structure policies and procedures in the following categories [*identify internal control structure categories*].

For all of the internal control structure categories listed above, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the general purpose financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control structure and its operations that we consider to be material weaknesses as defined above.

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[1] Describe any departure from the standard report.

[2] If the financial statements are on a basis other than GAAP the report should be modified.

However, we noted certain matters involving the internal control structure and its operation that we have reported to the management of City of Example, Any State in a separate letter dated August 15, 19XX.[3]

This report is intended for the information of the audit committee, management and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.

[*Signature*]

[*Date*]

[Source: SOP 92-7, *Audits of State and Local Governmental Entities Receiving Federal Financial Assistance.*]

[3] If a separate letter has not been issued, this paragraph should be omitted.

.30 Single Audit Report on the Internal Control Structure Used in Administering Federal Financial Assistance Programs

Independent Auditor's Report

We have audited the general purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19XX, and have issued our report thereon dated September 8, 19XX.[1] We have also audited City of Example, Any State's compliance with requirements applicable to major federal financial assistance programs and have issued our report thereon dated September 8, 19XX.

We conducted our audits in accordance with generally accepted auditing standards; *Government Auditing Standards,* issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Circular A-128, *Audits of State and Local Governments.* Those standards and OMB Circular A-128 require that we plan and perform the audit to obtain reasonable assurance about whether the general purpose financial statements are free of material misstatement and about whether City of Example, Any State complied with laws and regulations, non-compliance with which would be material to a major federal financial assistance program.

In planning and performing our audits for the year ended June 30, 19XX, we considered the City's internal control structure in order to determine our auditing procedures for the purpose of expressing our opinions on the City's general purpose financial statements and on its compliance with requirements applicable to major programs and to report on the internal control structure in accordance with OMB Circular A-128. This report addresses our consideration of internal control structure policies and procedures relevant to compliance with requirements applicable to federal financial assistance programs. We have addressed internal control structure policies and procedures relevant to our audit of the general purpose financial statements in a separate report dated September 8, 19XX.

The management of City of Example, Any State is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of general purpose financial statements in accordance with generally accepted accounting principles, and that federal financial assistance programs are managed in compliance with applicable laws and regulations.[2] Because of inherent limitations in any internal control structure, errors, irregularities, or instances of noncompliance may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

For the purpose of this report, we have classified the significant internal control structure policies and procedures used in administering federal financial assistance programs in the following categories [*identify internal control structure categories*].[3]

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[1] Describe any departure from the standard report.

[2] If the financial statements are on a basis other than GAAP the report should be modified.

[3] Following are examples of different ways in which internal control structure policies and procedures used in administering federal financial assistance programs might be classified. The auditor should modify these examples or use other classifications as appropriate for the particular circumstances on which the auditor is reporting. However, there is no need to present detailed internal control structure policies and procedures, even though test work may be performed at that level.

Activity Cycles

- Treasury or financing
- Revenue/receipts
- Purchases/disbursements
- External financial reporting

For all of the internal control structure categories listed above, we obtained an understanding of the design of relevant policies and procedures and determined whether they have been placed in operation, and we assessed control risk.

During the year ended June 30, 19XX, City of Example, Any State, expended X percent of its total federal financial assistance under major federal financial assistance programs.

We performed tests of controls, as required by OMB Circular A-128, to evaluate the effectiveness of the design and operation of internal control structure policies and procedures that we considered relevant to preventing or detecting material noncompliance with specific requirements, general requirements, and requirements governing claims for advances and reimbursements and amounts claimed or used for matching that are applicable to each of the City's major federal financial assistance programs, which are identified in the accompanying Schedule of Federal Financial Assistance. Our procedures were less in scope than would be necessary to render an opinion on these internal control structure policies and procedures. Accordingly, we do not express such an opinion.

We noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the City's ability to administer federal financial assistance programs in accordance with applicable laws and regulations.

[Include paragraphs to describe the reportable conditions noted.]

(Footnote Continued)

- Payroll/personnel

Financial Statement Captions
- Cash and cash equivalents
- Receivables
- Inventory
- Property and equipment
- Payables and accrued liabilities
- Debt
- Fund balance

Accounting Applications
- Billings
- Receivables
- Cash receipts
- Purchasing and receiving
- Accounts disbursements
- Payroll
- Inventory control
- Property and equipment
- General ledger

General Requirements
- Political activity
- Davis-Bacon Act
- Civil rights
- Cash management
- Relocation assistance and real property management
- Federal financial reports
- Allowable costs/cost principles
- Drug-free workplace
- Administration requirements

Specific Requirements
- Types of services
- Eligibility
- Matching, level of effort, or earmarking
- Reporting
- Cost allocation
- Special requirements, if any
- Monitoring subrecipients

Claims for Advances and Reimbursements

Amounts Claimed or Used for Matching

A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that noncompliance with laws and regulations that would be material to a federal financial assistance program may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure policies and procedures used in administering federal financial assistance would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe none of the reportable conditions described above is a material weakness.

We also noted other matters involving the internal control structure and its operation that we have reported to the management of City of Example, Any State in a separate letter dated September 8, 19XX.[4]

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

[*Signature*]

[*Date*]

[Source: SOP 92-7, *Audits of State and Local Governmental Entities Receiving Federal Financial Assistance.*]

[4] If a separate letter has not been issued, this paragraph should be omitted.

.31 Single Audit Report on the Internal Control Structure Used in Administering Federal Financial Assistance Programs—Total Assistance Expended Under Major Federal Financial Assistance Programs is Less Than 50 Percent of Federal Financial Assistance *

Independent Auditor's Report

We have audited the general purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19XX, and have issued our report thereon dated September 8, 19XX. We have also audited City of Example, Any State's compliance with requirements applicable to major federal financial assistance programs and have issued our report thereon dated September 8, 19XX.

We conducted our audits in accordance with generally accepted auditing standards; *Government Auditing Standards,* issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Circular A-128, *Audits of State and Local Governments.* Those standards and OMB Circular A-128 require that we plan and perform the audit to obtain reasonable assurance about whether the general purpose financial statements are free of material misstatement and about whether City of Example, Any State complied with laws and regulations, non-compliance with which would be material to a major federal financial assistance program.

In planning and performing our audits for the year ended June 30, 19XX, we considered the City's internal control structure in order to determine our auditing procedures for the purpose of expressing our opinions on the City's general purpose financial statements and on the compliance with requirements applicable to major programs and to report on the internal control structure in accordance with OMB Circular A-128. This report addresses our consideration of internal control structure policies and procedures relevant to compliance with requirements applicable to federal financial assistance programs. We have addressed internal control structure policies and procedures relevant to our audit of the general purpose financial statements in a separate report dated September 8, 19XX.

The management of City of Example, Any State is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of general purpose financial statements in accordance with generally accepted accounting principles, and federal financial assistance programs are managed in compliance with applicable laws and regulations. Because of inherent limitations in any internal control structure, errors, irregularities, or instances of noncompliance may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

For the purpose of this report, we have classified the significant internal control structure policies and procedures used in administering federal financial assistance programs in the following categories [*identify internal control structure categories*].

For all of the internal control structure categories listed above, we obtained an understanding of the design of relevant policies and procedures and determined whether they have been placed in operation, and we assessed control risk.

* See notes from AAM section 10,700.30.

During the year ended June 30, 19XX, City of Example, Any State, expended X percent of its total federal financial assistance under major federal financial assistance programs.

We performed tests of controls, as required by OMB Circular A-128, to evaluate the effectiveness of the design and operation of internal control structure policies and procedures that we considered relevant to preventing or detecting material noncompliance with specific requirements, general requirements, and requirements governing claims for advances and reimbursements and amounts claimed or used for matching that are applicable to each of the City's major federal financial assistance programs, which are identified in the accompanying Schedule of Federal Financial Assistance. Our procedures were less in scope than would be necessary to render an opinion on these internal control structure policies and procedures. Accordingly, we do not express such an opinion.

We noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the City's ability to administer federal financial assistance programs in accordance with applicable laws and regulations.

[*Include paragraphs to describe the reportable conditions noted.*]

Our consideration of the internal control structure policies and procedures used in administering federal financial assistance would not necessarily disclose all matters in the internal control structure that constitute material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that noncompliance with laws and regulations that would be material to a federal financial assistance program may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control structure and its operations that we consider to be material weaknesses as defined above.

We also noted other matters involving the internal control structure and its operation that we have reported to the management of [City of Example, Any State] in a separate letter dated September 8, 19XX.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

[*Signature*]

[*Date*]

[Source: SOP 92-7, *Audits of State and Local Governmental Entities Receiving Federal Financial Assistance.*]

.32 Single Audit Report on the Internal Control Structure Used in Administering Federal Financial Assistance Programs—No Major Programs *

Independent Auditor's Report

We have audited the general purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19XX, and have issued our report thereon dated September 8, 19XX.

We conducted our audits in accordance with generally accepted auditing standards; *Government Auditing Standards,* issued by the Comptroller General of the United States; and Office of Management and Budget Circular A-128, *Audits of State and Local Governments.* Those standards and OMB Circular A-128 require that we plan and perform the audit to obtain reasonable assurance about whether the general purpose financial statements are free of material misstatement and about whether City of Example, Any State complied with laws and regulations, noncompliance with which would be material to a federal financial assistance program.

In planning and performing our audit for the year ended June 30, 19XX, we considered the City's internal control structure in order to determine our auditing procedures for the purpose of expressing our opinions on the City's general purpose financial statements and to report on the internal control structure in accordance with OMB Circular A-128. This report addresses our consideration of internal control structure policies and procedures relevant to compliance with requirements applicable to federal financial assistance programs. We have addressed internal control structure policies and procedures relevant to our audit of the general-purpose financial statements in a separate report dated September 8, 19XX.

The management of City of Example, Any State is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of general purpose financial statements in accordance with generally accepted accounting principles, and that federal financial assistance programs are managed in compliance with applicable laws and regulations. Because of inherent limitations in any internal control structure, errors, irregularities, or instances of noncompliance may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

For the purpose of this report, we have classified the significant internal control structure policies and procedures used in administering federal financial assistance programs in the following categories [*identify internal control structure categories*].

For all of the internal control structure categories listed above, we obtained an understanding of the design of relevant policies and procedures and determined whether they have been placed in operation, and we assessed control risk.

During the year ended June 30, 19XX, City of Example, Any State, had no major federal financial assistance programs and expended X percent of its total federal financial assistance under nonmajor federal financial assistance programs: [*list appropriate nonmajor federal financial assistance programs*].

We performed tests of controls, as required by OMB Circular A-128, to evaluate the effectiveness of the design and operation of internal control structure policies and procedures that we have considered relevant to preventing or

* See notes in AAM section 10,700.30.

detecting material noncompliance with specific requirements, general requirements, and requirements governing claims for advances and reimbursements and amounts claimed or used for matching that are applicable to the aforementioned nonmajor programs. Our procedures were less in scope than would be necessary to render an opinion on these internal control structure policies and procedures. Accordingly, we do not express such an opinion.

We noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the City's ability to administer federal financial assistance programs in accordance with applicable laws and regulations.

[*Include paragraphs to describe the reportable conditions noted.*]

A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that noncompliance with laws and regulations that would be material to a federal financial assistance program may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure policies and procedures used in administering federal financial assistance would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe none of the reportable conditions described above is a material weakness.

We also noted other matters involving the internal control structure and its operation that we have reported to the management of City of Example, Any State in a separate letter dated September 8, 19XX.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.

[*Signature*]

[*Date*]

[Source: SOP 92-7, *Audits of State and Local Governmental Entities Receiving Federal Financial Assistance.*]

.33 Single Audit Report on the Internal Control Structure Used in Administering Federal Financial Assistance Programs—Material Weaknesses Identified*

Independent Auditor's Report

We have audited the general purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19XX, and have issued our report thereon dated September 8, 19XX. We have also audited City of Example, Any State's compliance with requirements applicable to major federal financial assistance programs and have issued our report thereon dated September 8, 19XX.

We conducted our audits in accordance with generally accepted auditing standards; *Government Auditing Standards,* issued by the Comptroller General of the United States; and Office of Management and Budget Circular A-128, *Audits of State and Local Governments.* Those standards and OMB Circular A-128 require that we plan and perform the audit to obtain reasonable assurance about whether the general purpose financial statements are free of material misstatement and about whether City of Example, Any State, complied with laws and regulations, noncompliance with which would be material to a major federal financial assistance program.

In planning and performing our audits for the year ended June 30, 19XX, we considered the City's internal control structure in order to determine our auditing procedures for the purpose of expressing our opinions on the City's general purpose financial statements and on its compliance with requirements applicable to major programs and to report on the internal control structure in accordance with OMB Circular A-128. This report addresses our consideration of internal control structure policies and procedures relevant to compliance with requirements applicable to federal financial assistance programs. We have addressed internal control structure policies and procedures relevant to our audit of the general purpose financial statements in a separate report dated September 8, 19XX.

The management of City of Example, Any State, is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of general purpose financial statements in accordance with generally accepted accounting principles, and that federal financial assistance programs are managed in compliance with applicable laws and regulations. Because of inherent limitations in any internal control structure, errors, irregularities, or instances of noncompliance may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

For the purpose of this report, we have classified the significant internal control structure policies and procedures used in administering federal financial assistance programs in the following categories: [*identify internal control structure categories*].

For all of the internal control structure categories listed above, we obtained an understanding of the design of relevant policies and procedures and determined whether they have been placed in operation, and we assessed control risk.

During the year ended June 30, 19XX, City of Example, Any State, expended X percent of its total federal financial assistance under major federal financial assistance programs.

* See notes in AAM section 10,700.30.

We performed tests of controls, as required by OMB Circular A-128, to evaluate the effectiveness of the design and operation of internal control structure policies and procedures that we considered relevant to preventing or detecting material noncompliance with specific requirements, general requirements, and requirements governing claims for advances and reimbursements and amounts claimed or used for matching that are applicable to each of the City's major federal financial assistance programs, which are identified in the accompanying Schedule of Federal Financial Assistance. Our procedures were less in scope than would be necessary to render an opinion on these internal control structure policies and procedures. Accordingly, we do not express such an opinion.

We noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the City's ability to administer federal financial assistance programs in accordance with applicable laws and regulations.

[*Include paragraphs to describe the reportable conditions noted.*]

A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that noncompliance with laws and regulations that would be material to a federal financial assistance program may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure policies and procedures used in administering federal financial assistance would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, that are also considered to be material weaknesses as defined above. However, we noted the following matters involving the internal control structure and its operation that we consider to be material weaknesses as defined above. These conditions were considered in determining the nature, timing, and extent of the procedures to be performed in our audit of City of Example, Any State's compliance with requirements applicable to its major federal financial assistance programs for the year ended June 30, 19XX, and this report does not affect our report thereon dated September 8, 19XX.

[*A description of the material weaknesses that have come to the auditor's attention would follow.*]

We also noted other matters involving the internal control structure and its operation that we have reported to the management of City of Example, Any State in a separate letter dated September 8, 19XX.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.

[*Signature*]

[*Date*]

[Source: SOP 92-7, *Audits of State and Local Governmental Entities Receiving Federal Financial Assistance.*]

[The next page is 10,951.]

AAM Section 10,800

Reports on Employee Benefit Plans

.01 Unqualified Opinion—Defined Benefit Plan Assuming End-of-Year Benefit Information Date

Independent Auditor's Report

Addressee:

We have audited the accompanying statements of net assets available for benefits of XYZ Pension Plan as of December 31, 19X2 and 19X1 and of accumulated plan benefits as of December 31, 19X2, and the related statements of changes in net assets available for benefits and of changes in accumulated plan benefits for the year ended December 31, 19X2. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our 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 status of the Plan as of December 31, 19X2 and information regarding the Plan's net assets available for benefits as of December 31, 19X1, and the changes in its financial status for the year ended December 31, 19X2 in conformity with generally accepted accounting principles.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide, *Audits of Employee Benefit Plans*, paragraph 13.04.]

NOTE:

Department of Labor Regulations, section 2520.103-1 requires the accountant's report to be dated, signed manually, indicate the city and state where issued and identify the financial statements covered by the report. Due to these requirements, the accountant's reports which relate to Employee Benefit Plans include the city and state in the complimentary closing as well as the signature and date.

.02 Unqualified Opinion—Defined Benefit Plan Assuming Beginning-of-Year Benefit Information Date

Independent Auditor's Report

Addressee:

We have audited the accompanying statements of net assets available for benefits of XYZ Pension Plan as of December 31, 19X2 and 19X1, and the related statements of changes in net assets available for benefits for the years then ended and the statement of accumulated plan benefits as of December 31, 19X1, and the related statement of changes in accumulated plan benefits for the year then ended. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with 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 status of the Plan as of December 31, 19X1, and the changes in its financial status for the year then ended and information regarding net assets available for benefits and changes therein as of and for the year ended December 31, 19X2 in conformity with generally accepted accounting principles.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide, *Audits of Employee Benefit Plans*, paragraph 13.05.]

.03 Unqualified Opinion—Defined Contribution Profit-Sharing Plan

Independent Auditor's Report

Addressee:

We have audited the accompanying statements of net assets available for benefits of ABC Company Profit-Sharing Plan as of December 31, 19X1 and 19X0, and the related statement of changes in net assets available for benefits for the year ended December 31, 19X1. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our 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 net assets available for benefits of the Plan as of December 31, 19X1 and 19X0, and the changes in net assets available for benefits for the year ended December 31, 19X1 in conformity with generally accepted accounting principles.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide, *Audits of Employee Benefit Plans*, paragraph 13.06.]

.04 Unqualified Opinion—Employee Health and Welfare Benefit Plan*

Independent Auditor's Report

Addressee:

We have audited the accompanying statement of net assets of Bizco Corporation Employee Health and Welfare Benefit Plan as of December 31, 19X1, and the related statement of changes in net assets for the year then ended. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our 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 net assets of the Plan as of December 31, 19X1, and the changes in net assets for the year then ended in conformity with generally accepted accounting principles.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide, *Audits of Employee Benefit Plans*, paragraph 13.07.]

* This is an illustration of an auditor's report with an unqualified opinion on the financial statements of an employee health and welfare plan prepared in accordance with chapter 4 of the AICPA Audit and Accounting Guide (the Guide), *Audits of Employee Benefit Plans*. Chapter 4 of the Guide has been superseded by AICPA Statement of Position (SOP) 92-6, *Accounting and Reporting by Health and Welfare Benefit Plans*. SOP 92-6 is effective for audits of financial statements of single-employer plans for plan years beginning after December 15, 1992, except that application of the SOP by single-employer plans with no more than 500 participants is effective for plan years beginning after December 15, 1994. SOP 92-6 is effective for audits of financial statements of multi-employer plans for plan years beginning after December 15, 1995. Earlier application is encouraged. When a plan adopts the SOP it must be adopted in its entirety.

An illustration of an auditor's report assuming the provisions of SOP 92-6 have been adopted is presented in AAM section 10,800.13.

.05 Unqualified Opinion—Supplemental Schedules Required by ERISA and DOL Regulations

Our audits were performed for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplemental schedules of (*identify*) are presented for the purpose of additional analysis and are not a required part of the basic financial statements but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974 and are not a required part of the basic financial statements. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[Source: AICPA Audit and Accounting Guide, *Audits of Employee Benefit Plans*, paragraph 13.11.]

NOTES:

This paragraph can be shown separately in the auditor-submitted document or as a separate paragraph, after the opinion paragraph, of the auditor's standard report, when the auditor's report covers additional information and the auditor has applied auditing procedures and is expressing an opinion on the additional information.

Examples of paragraphs that should be added to the standard auditor's report when the report on the supplemental schedules is modified because of omitted information or an omitted schedule required by DOL regulations are presented in AAM section 10,800.14—.16.

.06 Unqualified Opinion—Defined Benefit Pension Plan Prepared on a Cash Basis

Independent Auditor's Report

Addressee:

We have audited the accompanying statements of net assets available for plan benefits (modified cash basis) of XYZ Pension Plan as of December 31, 19X2 and 19X1, and the related statement of changes in net assets available for plan benefits (modified cash basis) for the year ended December 31, 19X2. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets available for benefits and the accumulated plan benefits of XYZ Pension Plan as of December 31, 19X2 and 19X1, and the changes in net assets available for benefits and changes in accumulated plan benefits for the year ended December 19X2, on the basis of accounting described in Note X.

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules (modified cash basis) of (1) assets held for investment, (2) transactions in excess of X percent of the current value of plan assets, and (3) investments in loans and fixed income obligations in default or classified as uncollectible as of or for the year ended December 31, 19X2, are presented for additional analysis and are not a required part of the basic financial statements, but are supplemental information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide, *Audits of Employee Benefit Plans*, paragraph 13.21.]

.07 Limited-Scope Audits Under DOL Regulations

Independent Auditor's Report

Addressee:

We were engaged to audit the financial statements and supplemental schedules of XYZ Pension Plan as of December 31, 19X1 and 19X0 and for the year ended December 31, 19X1, as listed in the accompanying index. These financial statements and schedules are the responsibility of the Plan's management.

As permitted by 29 CFR 2520.103-8 of the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974, the plan administrator instructed us not to perform, and we did not perform, any auditing procedures with respect to the information summarized in Note X, which was certified by ABC Bank, the trustee (or custodian) of the Plan, except for comparing such information with the related information included in the financial statements and supplemental schedules. We have been informed by the plan administrator that the trustee (or custodian) holds the Plan's investment assets and executes investment transactions. The plan administrator has obtained a certification from the trustee (or custodian) as of and for the years ended December 31, 19X1 (and 19X2) that the information provided to the plan administrator by the trustee (or custodian) is complete and accurate.

Because of the significance of the information that we did not audit, we are unable to, and do not, express an opinion on the accompanying financial statements and schedules taken as a whole. The form and content of the information included in the financial statements and schedules, other than that derived from the information certified by the trustee (or custodian), have been audited by us in accordance with generally accepted auditing standards and, in our opinion, are presented in compliance with the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide, *Audits of Employee Benefit Plans,* paragraph 13.25.]

.08 Limited-Scope Audit in Prior Year

Independent Auditor's Report

Addressee:

We have audited the accompanying statements of net assets available for benefits of XYZ Pension Plan as of December 31, 19X2 and 19X1, and the related statement of changes in net assets available for benefits for the year ended December 31, 19X2 and the statements of accumulated plan benefits as of December 31, 19X2 and 19X1, and the related statement of changes in accumulated plan benefits for the year ended December 31, 19X2. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as explained in the following paragraph, we conducted our audits in accordance with 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 permitted by 29 CFR 2520.103-8 of the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974, investment assets held by ABC Bank, the trustee (or custodian) of the Plan, and transactions in those assets were excluded from the scope of our audit of the Plan's 19X1 financial statements, except for comparing the information provided by the trustee (or custodian), which is summarized in Note X, with the related information included in the financial statements.

Because of the significance of the information that we did not audit, we are unable to, and do not, express an opinion on the Plan's financial statements as of December 31, 19X1. The form and content of the information included in the 19X1 financial statements, other than that derived from the information certified by the trustee (or custodian), have been audited by us and, in our opinion, are presented in compliance with the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

In our opinion, the financial statements, referred to above, of XYZ Pension Plan as of December 31, 19X2, and for the year then ended present fairly, in all material respects, the financial status of XYZ Pension Plan as of December 31, 19X2, and changes in its financial status for the year then ended in conformity with generally accepted accounting principles.

Our audit of the Plan's financial statements as of and for the year ended December 31, 19X2, was made for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules of (1) assets held for investment, (2) transactions in excess of X percent of the current value of plan assets, and (3) investments in loans and fixed income obligations in default or classified as uncollectible as of or for the year ended December 31, 19X2, are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. The supplemental schedules have been subjected to the auditing procedures applied in the audit of the basic financial statements for the year ended December 31, 19X2, and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide, *Audits of Employee Benefit Plans*, paragraph 13.26.]

.09 Limited-Scope Audit in Current Year

Independent Auditor's Report

Addressee:

We were engaged to audit the accompanying statement of net assets available for benefits of XYZ Pension Plan as of December 31, 19X2 and 19X1, and the related statement of changes in net assets available for plan benefits for the year ended December 31, 19X2 and the supplemental schedules of (1) assets held for investment purposes, (2) transactions in excess of 5 percent of the current value of plan assets, and (3) investments in loans and fixed income obligations in default or classified as uncollectible as of or for the year ended December 31, 19X2. These financial statements are the responsibility of the Plan's management.

As permitted by 29 CFR 2520.103-8 of the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974, the plan administrator instructed us not to perform, and we did not perform, any auditing procedures with respect to the information summarized in Note X, which was certified by ABC Bank, the trustee (or custodian) of the Plan, except for comparing the information with the related information included in the 19X2 financial statements and supplemental schedules. We have been informed by the plan administrator that the trustee (or custodian) holds the Plan's investment assets and executes investment transactions. The plan administrator has obtained a certification from the trustee (or custodian) as of and for the year ended December 31, 19X2, that the information provided to the plan administrator by the trustee (or custodian) is complete and accurate.

Because of the significance of the information in the Plan's 19X2 financial statements that we did not audit, we are unable to, and do not, express an opinion on the accompanying financial statements and supplemental schedules as of or for the year ended December 31, 19X2. The form and content of the information included in the financial statements and supplemental schedules, other than that derived from the information certified by the trustee (or custodian), have been audited by us in accordance with generally accepted auditing standards and, in our opinion, are presented in compliance with the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

We have audited the statement of net assets available for benefits of XYZ Pension Plan as of December 31, 19X1 and, in our report dated May 20, 19X2, we expressed our opinion that such financial statement presents fairly, in all material respects, the financial status of XYZ Pension Plan as of December 31, 19X1, in conformity with generally accepted accounting principles.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide, *Audits of Employee Benefit Plans*, paragraph 13.27.]

.10 Multiemployer Pension Plan Assuming Limited-Scope Audit

Independent Auditor's Report

Addressee:

We were engaged to audit the statements of (*identify*) of XYZ Multiemployer Pension Plan as of December 31, 19X2 and 19X1 and for the years then ended. These financial statements are the responsibility of the Plan's management.

The Plan's records and procedures are not adequate to assure the completeness of participants' data on which contributions and benefit payments are determined, and the Board of Trustees did not engage us to perform, and we did not perform, any other auditing procedures with respect to participants' data maintained by the sponsor companies or individual participants.

Because of the significance of the information that we did not audit, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on these financial statements.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide, *Audits of Employee Benefit Plans*, paragraph 13.28.]

.11 Trust Established Under an Employee Benefit Plan

Independent Auditor's Report

Addressee:

We have audited the accompanying statement of net assets of ABC Pension Trust as of December 31, 19X2, and the related statement of changes in net assets and trust balance for the year then ended. These financial statements are the responsibility of the Trust's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with 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 net assets of ABC Pension Trust as of December 31, 19X2, and the changes in its net assets and trust balance for the year then ended in conformity with generally accepted accounting principles.

The accompanying statements are those of ABC Pension Trust, which is established under XYZ Pension Plan; the statements do not purport to present the financial status of XYZ Pension Plan. The statements do not contain certain information on accumulated plan benefits and other disclosures necessary for a fair presentation of the financial status of XYZ Pension Plan in conformity with generally accepted accounting principles. Furthermore, these statements do not purport to satisfy the Department of Labor reporting and disclosure requirements relating to the financial statements of employee benefit plans.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide, *Audits of Employee Benefit Plans*, paragraph 13.29.]

.12 Defined Benefit Plan Assuming Inadequate Procedures to Value Investments

Independent Auditor's Report

Addressee:

We have audited the accompanying statements of net assets available for benefits of XYZ Pension Plan as of December 31, 19X2 and 19X1 and of accumulated plan benefits as of December 31, 19X2, and the related statements of changes in net assets available for benefits and of changes in accumulated plan benefits for the year ended December 31, 19X2. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our 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.

As discussed in Note X, investments amounting to $________ (________ percent of net assets available for benefits) as of December 31, 19X2, have been valued at estimated fair value as determined by the Board of Trustees. We have reviewed the procedures applied by the trustees in valuing the securities and have inspected the underlying documentation. In our opinion, those procedures are not adequate to determine the fair value of the investments in conformity with generally accepted accounting principles. The effect on the financial statements and supplemental schedules of not applying adequate procedures to determine the fair value of the securities is not determinable.

In our opinion, except for the effects of the procedures used by the Board of Trustees to determine the valuation of investments as described in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial status of XYZ Pension Plan as of December 31, 19X2, and information regarding the plan's net assets available for benefits as of December 31, 19X1, and the changes in its financial status for the year ended December 31, 19X2 in conformity with generally accepted accounting principles.

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules of (1) assets held for investment, (2) transactions in excess of X percent of the current value of plan assets, and (3) investments in loans and fixed income obligations in default or classified as uncollectible as of or for the year ended December 31, 19X2, are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. That additional information has been subjected to the auditing procedures applied in the audit of the basic financial statements for the year ended December 31, 19X2; and in our opinion, except for the effects of the valuation of investments, as described above, the additional information is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide, *Audits of Employee Benefit Plans*, paragraph 13.32.]

.13 Unqualified Opinion—Employee Health and Welfare Benefit Plans*

Independent Auditors' Report

Addressee:

We have audited the accompanying statements of net assets available for benefits and of plan benefit obligations of Allied Industries Benefit Plan as of December 31, 19X2 and 19X1, and the related statement of changes in net assets available for benefits and of changes in plan benefits obligations for the year ended December 31, 19X2. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with 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 status of the Plan as of December 31, 19X2 and 19X1, and the changes in financial status for the year ended December 31, 19X2 in conformity with generally accepted accounting principles.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide, *Audits of Employee Benefit Plans,* paragraph 13.08.]

* This is an illustration of an auditor's report with an unqualified opinion on the financial statement of an employee health and welfare plan prepared in accordance with AICPA Statement of Position (SOP) 92-6, *Accounting and Reporting by Employee Health and Welfare Benefit Plans.* SOP 92-6 is effective for audits of financial statements of single-employer plans for plan years beginning after December 15, 1992, except that the application to single-employer plans with no more than 500 participants is effective for plan years beginning after December 15, 1994. SOP 92-6 if effective for audits of financial statements of multiemployer plans for plan years beginning after December 15, 1995. Earlier application is encouraged. When a plan adopts the SOP it must be adopted in its entirety.

An illustration of an auditor's report assuming the provisions of SOP 92-6 have not yet been adopted is presented in AAM section 10,800.04.

.14 Modified Report—Omitted Information or Omitted Schedule Required Under DOL Regulations

Following are examples of paragraphs that should be added to the auditor's report when the auditor should modify his or her report on the supplemental schedules because of omitted information or an omitted schedule which is required under DOL regulations.

Independent Auditors' Report

Addressee:

[*Same first, second, and third paragraphs as the standard report.*]

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules of *[identify]* are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations of Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

The schedule of assets held for investment purposes that accompanies the Plan's financial statements does not disclose the historical cost of certain plan assets held by the Plan trustee [or custodian]. Disclosure of this information is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

or

The Plan has not presented the schedule of reportable transactions (transactions in excess of 5 percent of the current value of plan assets at the beginning of the year). Disclosure of this information is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide, *Audits of Employee Benefit Plans,* paragraph 13.16.]

.15 Qualified Opinion—Omitted or Incomplete Schedule or Material Inconsistency

The following paragraphs should be added to the auditor's report when the auditor concludes that his or her opinion on the supplemental schedules should be qualified because a schedule, or information thereon, was omitted (when the schedules are not covered by a trustee's certification as to completeness and accuracy), or because information in a required schedule is materially inconsistent with the financial statements.

Independent Auditors' Report

Addressee:

[*Same first, second, and third paragraphs as the standard report.*]

The schedule of assets held for investment purposes that accompanies the Plan's financial statements does not disclose that the Plan had loans to participants which are considered assets held for investment purposes. Disclosure of this information is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules of *[identify]* are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, except for the omission of the information discussed in the preceding paragraph, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide, *Audits of Employee Benefits Plans,* paragraph 13.16.]

.16 Modified Report—Omitted Information or Omitted Schedule Required Under DOL Regulations in a Limited Scope Engagement

Independent Auditors' Report

Addressee:

[*Same first and second paragraphs as the limited-scope report.*]

The schedule of assets held for investment purposes that accompanies the Plan's financial statements does not disclose that the Plan has loans to participants which are considered assets held for investment purposes. Disclosure of this information is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

or

The Plan has not presented the schedule of reportable transactions (transactions in excess of 5 percent of the current value of plan assets at the beginning of the year). Disclosure of this information is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

Because of the significance of the information that we did not audit, we are unable to, and do not, express an opinion on the accompanying financial statements and schedules taken as a whole. The form and content of the information included in the financial statements and schedules, other than that derived from the information certified by the trustee, have been audited by us in accordance with generally accepted auditing standards and, in our opinion, except for the omission of the information discussed in the preceding paragraph, are presented in compliance with the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide, *Audits of Employee Benefit Plans,* paragraph 13.16.]

.17 Qualified Opinion—Disclosure of Material Prohibited Transaction With Party in Interest Omitted**

The following paragraphs should be added to the auditor's report on the plan's financial statements when the auditor concludes that his or her opinion on the supplemental schedules should be qualified because disclosure of a material prohibited transaction with a party in interest is omitted.

Independent Auditors' Report

Addressee:

[*Same first, second, and third paragraphs as the standard report.*]

The schedule of prohibited transactions that accompanies the plan's financial statements does not disclose that the Plan [*describe prohibited transaction*]. In our opinion, disclosure of this information is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules [*identify*] are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, except for the omission of the information discussed in the preceding paragraph, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide, *Audits of Employee Benefit Plans,* paragraph 13.17.]

** Note: If a material party in interest transaction that is not disclosed in the supplementary schedule is also considered a related-party transaction and if that transaction is not properly disclosed in the notes to the financial statements, the auditor should express a qualified or adverse opinion on the financial statements as well as on the supplemental schedule. See AAM section 10,800.20.

.18 Adverse Opinion—Disclosure of Material Prohibited Transaction With Party in Interest Omitted

The following paragraphs should be added to the auditor's report on the plan's financial statements when the auditor decides that an adverse opinion should be expressed on the supplemental schedules because disclosure of a material prohibited transaction with a party in interest is omitted.

Independent Auditors' Report

Addressee:

[*Same first, second, and third paragraphs as the standard report.*]

The schedule of prohibited transactions that accompanies the plan's financial statements does not disclose that the Plan [*describe prohibited transaction*]. In our opinion, disclosure of this information is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules of [*identify*] are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, because of the omission of the information discussed in the preceding paragraph are not fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide, *Audits of Employee Benefit Plans,* paragraph 13.17.]

[The next page is 10,969-3.]

.19 Modified Report—Disclosure of Immaterial Prohibited Transaction With Party in Interest Omitted

The following paragraphs should be added to the auditor's report on the plan's financial statements when the auditor decides to modify his or her report on the supplemental schedules because disclosure of a prohibited transaction with a party in interest that is not material to the financial statements has been omitted.

Independent Auditors' Report

Addressee:

[*Same first, second, and third paragraphs as the standard report.*]

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules of [*identify*] are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

The schedule of prohibited transactions that accompanies the plan's financial statements does not disclose that the Plan [*describe prohibited transaction*]. Disclosure of this information, which is not considered material to the financial statements taken as a whole, is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide, *Audits of Employee Benefit Plans,* paragraph 13.17.]

.20 Qualified Opinion—Disclosure of Material Prohibited Transaction With Party in Interest Omitted—Related-Party Transaction

Independent Auditors' Report

Addressee:

We have audited the accompanying statement of net assets available for benefits of XYZ Company Profit-Sharing Plan as of December 31, 19X1 and 19X0, and the related statement of changes in net assets available for benefits for the year ended December 31, 19X1. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with 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 Plan's financial statements do not disclose that the Plan [*describe related-party transaction*]. Disclosure of this information is required by generally accepted accounting principles.

In our opinion, except for the omission of the information discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the net assets available for benefits of the Plan as of December 31, 19X1 and 19X0, and the changes in net assets available for benefits for the year ended December 31, 19X1 in conformity with generally accepted accounting principles.

The schedule of prohibited transactions that accompanies the plan's financial statements does not disclose that the plan [*describe prohibited transaction*]. Disclosure of this information is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules of [*identify*] are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, except for the omission of the information discussed in the preceding paragraph, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide, *Audits of Employee Benefit Plans,* paragraph 13.18.]

.21 Defined Benefit Plan Assuming Nonreadily Marketable Investments

Independent Auditors' Report

Addressee:

[*Same first and second paragraphs as the standard report.*]

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets available for benefits of the Plan as of December 31, 19X1 and 19X0, and the changes in net assets available for benefits for the year ended December 31, 19X1 in conformity with generally accepted accounting principles.

As explained in note 2, the financial statements include securities valued at $ ———— (——— percent of net assets), whose values have been estimated by the Board of Trustees in the absence of readily ascertainable market values. We have reviewed the procedures used by the Board of Trustees in arriving at its estimate of value of such securities and have inspected underlying documentation, and, in the circumstances, we believe the procedures are reasonable and the documentation appropriate. However, because of the inherent uncertainty of valuation, those estimated values may differ significantly from the values that would have been used had a ready market for the securities existed, and the differences could be material.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide, *Audits of Employee Benefit Plans,* paragraph 13.31.]

.22 Savings Plan Containing Separate Investment Fund Option Information

Independent Auditor's Report

Addressee:

We have audited the accompanying statements of net assets available for benefits* of XYZ Employee Savings Plan as of December 31, 19X2 and 19X1, and the related statement of changes in net assets available for benefits for the year ended December 31, 19X2. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with 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 of disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets available for benefits of the Plan as of December 31, 19X2 and 19X1, and the changes in net assets available for benefits for the year ended December 31, 19X2, in conformity with generally accepted accounting principles.

Our audits were performed for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplemental schedules of [*insert titles of DOL required schedules*] are presented for the purpose of additional analysis and are not a required part of the basic financial statements but are supplementary information required by the Department for Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. The Fund Information in the [statement of net assets available for benefits and the] statement of changes in net assets available for benefits is presented for purposes of additional analysis rather than to present the [net assets available for plan benefits and] changes in net assets available for plan benefits of each fund. The supplemental schedules and Fund Information have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide, *Audits of Employee Benefit Plans,* paragraph 13.36.]

* If the financial statements are included in an SEC filing not subject to ERISA, the words "including the schedules of investments" would be added here. Additionally, the report would cover the required statements of changes in net assets available for plan benefits for each of the three years in the period ended December 31, 19X2.

AAM Section 10,850

Reports on Financial Statements of Brokers and Dealers in Securities

.01 Unqualified Opinion on Financial Statements and Supplementary Schedules Required by the SEC

Independent Auditor's Report

Addressee:

We have audited the accompanying consolidated statement of financial condition of Standard Stockbrokerage Co., Inc. and Subsidiaries as of December 31, 19X1, and the related consolidated statements of income, changes in stockholders' equity, changes in liabilities subordinated to claims of general creditors, and cash flows for the year then ended. 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.[1]

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Standard Stockbrokerage Co., Inc. and Subsidiaries as of December 31, 19X1, and the results of their operations and their 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 contained in Schedules I, II, III, and IV is presented for purposes of additional analysis and is not a required part of the basic financial statements, but is supplementary information required by rule 17a-5 of the Securities and Exchange Commission. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: SOP 89-1, *Reports on Audited Financial Statements of Brokers and Dealers in Securities.*]

[1] In February, 1989, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows From Certain Securities Held for Resale.* That statement amends FASB Statement No. 95, *Statement of Cash Flows,* to exempt certain investment companies that meet specified criteria from the requirement to provide a statement of cash flows.

NOTE:

SEC Regulation S-X section 210.2-02 requires the accountant's report to be dated, signed manually, indicate the city and state where issued, and identify without detailed enumeration the financial statements covered by the report. Due to these requirements the accountant's reports which relate to brokers and dealers in securities and investment companies include the city and state in the complimentary closing as well as the signature and date.

.02 Qualified Opinion—Departure From GAAP

Independent Auditor's Report

Addressee:

We have audited the accompanying consolidated statement of financial condition of Standard Stockbrokerage Co., Inc. and Subsidiaries as of December 31, 19X1, and the related consolidated statements of income, changes in stockholders' equity, changes in liabilities subordinated to claims of general creditors, and cash flows for the year then ended. 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.

As discussed in Note X to the financial statements, investment securities not readily marketable amounting to $XX,XXX (XX percent of stockholders' equity) as of December 31, 19X1, have been valued at fair value as determined by the Board of Directors. We have reviewed the procedures applied by the directors in valuing such securities and investments and have inspected underlying documentation. In our opinion, those procedures are not reasonable, and the documentation is not appropriate to determine fair value of securities in conformity with generally accepted accounting principles. The effect on the financial statements of not applying adequate valuation procedures is not readily determinable.

In our opinion, except for the effects on the financial statements of the valuation of investment securities determined by the Board of Directors, as described in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Standard Stockbrokerage Co., Inc. and Subsidiaries as of December 31, 19X1, and the results of their operations and their 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 contained in Schedules I, II, III, and IV is presented for purposes of additional analysis and is not a required part of the basic financial statements, but is supplementary information required by rule 17a-5 of the Securities and Exchange Commission. Such information has been subjected to the auditing procedures applied in our audit of the basic financial statements and, in our opinion, except for the effects on [*identify the schedules affected*] of the valuation of investment securities determined by the Board of Directors, as described in the second preceding paragraph, the information is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: SOP 89-1, *Reports on Audited Financial Statements of Brokers and Dealers in Securities.*]

NOTES:

SEC regulations require auditors to state if they have reviewed the procedures applied by the directors in valuing the securities, if they have inspected the underlying documentation, and if they believe the procedures are reasonable and documentation appropriate.

In certain circumstances, depending on materiality, the qualification could apply only to the income statement.

.03 Unqualified Opinion With an Explanatory Paragraph for Uncertainty of Valuation

Independent Auditor's Report

Addressee:

We have audited the accompanying consolidated statement of financial condition of Standard Stockbrokerage Co., Inc. and Subsidiaries as of December 31, 19X1, and the related consolidated statements of income, changes in stockholders' equity, changes in liabilities subordinated to claims of general creditors, and cash flows for the year then ended. 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 consolidated financial position of Standard Stockbrokerage Co., Inc. and Subsidiaries as of December 31, 19X1, and the results of their operations and their cash flows for the year then ended in conformity with generally accepted accounting principles.

As discussed in Note X to the financial statements, investment securities not readily marketable amounting to $XX,XXX (XX percent of stockholders' equity) as of December 31, 19X1, have been valued at fair value as determined by the Board of Directors. We have reviewed the procedures applied by the directors in valuing such securities and investments and have inspected underlying documentation, and in the circumstances, we believe the procedures are reasonable and the documentation appropriate. However, because of the inherent uncertainty of valuation, the Board of Directors' estimate of fair values may differ significantly from the values that would have been used had a ready market existed for the securities, and the differences could be material.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information contained in Schedules I, II, III, and IV is presented for purposes of additional analysis and is not a required part of the basic financial statements, but is supplementary information required by rule 17a-5 of the Securities and Exchange Commission. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: SOP 89-1, *Reports on Audited Financial Statements of Brokers and Dealers in Securities.*]

.04 Separate Report on Supplementary Schedules

Independent Auditor's Report on Supplementary Information Required by Rule 17a-5 of the Securities and Exchange Commission

Addressee:

We have audited the accompanying consolidated financial statements of Standard Stockbrokerage Co., Inc. and Subsidiaries as of and for the year ended December 31, 19X1, and have issued our report thereon dated February 15, 19X2. Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information contained in Schedules I, II, III, and IV is presented for purposes of additional analysis and is not a required part of the basic financial statements, but is supplementary information required by rule 17a-5 of the Securities and Exchange Commission. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: SOP 89-1, *Reports on Audited Financial Statements of Brokers and Dealers in Securities.*]

[The next page is 10,981.]

AAM Section 10,900

Reports for Investment Companies

.01 Unqualified Opinion on the Financial Statements

Independent Auditor's Report

Addressee:

We have audited the accompanying statement of assets and liabilities of XYZ Investment Company, including the schedule of portfolio investments, as of December 31, 19X4, and the related statements of operations and cash flows * for the year then ended, the statement of changes in net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended. These financial statements and per share data and ratios are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and per share data and ratios 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 and per share data and ratios are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Our procedures included confirmation of securities owned as of December 31, 19X4, by correspondence with the custodian and brokers. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements and selected per share data and ratios referred to above present fairly, in all material respects, the financial position of XYZ Investment Company as of December 31, 19X4, the results of its operations and its cash flows * for the year then ended, the changes in its net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended, in conformity with generally accepted accounting principles.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: SOP 89-2, *Reports on Audited Financial Statements of Investment Companies.*]

* In February, 1989, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows From Certain Securities Held for Resale.* That statement amends FASB Statement No. 95, *Statement of Cash Flows,* to exempt certain investment companies that meet specified criteria from the requirement to provide a statement of cash flows.

.02 Unqualified Opinion on the Financial Statements for a Multicolumnar Presentation of the Portfolios Constituting the Series

Independent Auditor's Report

Addressee:

We have audited the accompanying statements of assets and liabilities, including the schedules of investments, of XYZ Series Investment Company (comprising, respectively, the Foreign, Domestic Common Stock, Long-Term Bond, and Convertible Preferred Portfolios) as of December 31, 19X4, and the related statements of operations and cash flows* for the year then ended, the statements of changes in net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended. These financial statements and per share data and ratios are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and per share data and ratios 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 and per share data and ratios are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Our procedures included confirmation of securities owned as of December 31, 19X4, by correspondence with the custodian and brokers. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements and selected per share data and ratios referred to above present fairly, in all material respects, the financial position of each of the respective portfolios constituting the XYZ Series Investment Company as of December 31, 19X4, the results of their operations and their cash flows* for the year then ended, the changes in their net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended, in conformity with generally accepted accounting principles.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: SOP 89-2, *Reports on Audited Financial Statements of Investment Companies.*]

* In February, 1989, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows From Certain Securities Held for Resale.* That statement amends FASB Statement No. 95, *Statement of Cash Flows,* to exempt certain investment companies that meet specified criteria from the requirement to provide a statement of cash flows.

.03 Unqualified Opinion on the Financial Statements Presenting One of the Portfolios or Entities Constituting the Series

Independent Auditor's Report

Addressee:

We have audited the accompanying statement of assets and liabilities, including the schedule of portfolio investments, of the Convertible Preferred Portfolio (one of the portfolios constituting the XYZ Series Investment Company) as of December 31, 19X4, and the related statements of operations and cash flows* for the year then ended, the statements of changes in net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended. These financial statements and per share data and ratios are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and per share data and ratios 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 and per share data and ratios are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Our procedures included confirmation of securities owned as of December 31, 19X4, by correspondence with the custodian and brokers. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements and selected per share data and ratios referred to above present fairly, in all material respects, the financial position of the Convertible Preferred Portfolio of the XYZ Series Investment Company as of December 31, 19X4, and the results of its operations and cash flows* for the year then ended, the changes in its net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended, in conformity with generally accepted accounting principles.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: SOP 89-2, *Reports on Audited Financial Statements of Investment Companies.*]

* In February, 1989, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows From Certain Securities Held for Resale.* That statement amends FASB Statement No. 95, *Statement of Cash Flows,* to exempt certain investment companies that meet specified criteria from the requirement to provide a statement of cash flows.

.04 Unqualified Opinion on the Financial Statements With an Explanatory Paragraph Due to Absence of Ascertainable Market Values (Documentation Supports Valuation)

Independent Auditor's Report

Addressee:

We have audited the accompanying statement of assets and liabilities of XYZ Investment Company, including the schedule of portfolio investments, as of December 31, 19X4, and the related statements of operations and cash flows* for the year then ended, the statement of changes in net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended. These financial statements and per share data and ratios are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and per share data and ratios 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 and per share data and ratios are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Our procedures included confirmation of securities owned as of December 31, 19X4, by correspondence with the custodian and brokers. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements and selected per share data and ratios referred to above present fairly, in all material respects, the financial position of XYZ Investment Company as of December 31, 19X4, the results of its operations and its cash flows* for the year then ended, the changes in its net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended, in conformity with generally accepted accounting principles.

As explained in Note 2, the financial statements include securities valued at $ ____ (____% of net assets), whose values have been estimated by the Board of Directors in the absence of readily ascertainable market values. We have reviewed the procedures used by the Board of Directors in arriving at its estimate of value of such securities and have inspected underlying documentation, and, in the circumstances, we believe the procedures are reasonable and the documentation appropriate. However, because of the inherent uncertainty of valuation, those estimated values may differ significantly from the values that would have been used had a ready market for the securities existed, and the differences could be material.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: SOP 89-2, *Reports on Audited Financial Statements of Investment Companies.*]

* In February, 1989, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows From Certain Securities Held for Resale.* That statement amends FASB Statement No. 95, *Statement of Cash Flows,* to exempt certain investment companies that meet specified criteria from the requirement to provide a statement of cash flows.

.05 Qualified Opinion on the Financial Statements Due to Absence of Ascertainable Market Values (Documentation Does Not Support Valuation)

Independent Auditor's Report

Addressee:

We have audited the accompanying statement of assets and liabilities of XYZ Investment Company, including the schedule of portfolio investments, as of December 31, 19X4, and the related statements of operations and cash flows* for the year then ended, the statement of changes in net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended. These financial statements and per share data and ratios are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and per share data and ratios 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 and per share data and ratios are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Our procedures included confirmation of securities owned as of December 31, 19X4, by correspondence with the custodian and brokers. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As explained in Note 2, the financial statements include securities valued at $____ (____% of net assets), whose values have been estimated by the Board of Directors in the absence of readily ascertainable market values. We have reviewed the procedures used by the Board of Directors in arriving at its estimate of value of such securities and have inspected underlying documentation. In our opinion, those procedures are not reasonable, and the documentation is not appropriate to determine the value of the securities in conformity with generally accepted accounting principles. The effect on the financial statements of not applying adequate valuation procedures is not readily determinable.

In our opinion, except for the effects on the financial statements and selected per share data and ratios of the valuation of investment securities determined by the Board of Directors, as described in the preceding paragraph, the financial statements and selected per share data and ratios referred to above present fairly, in all material respects, the financial position of XYZ Investment Company as of December 31, 19X4, the results of its operations and its cash flows* for the year then ended, the changes in its net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended, in conformity with generally accepted accounting principles.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: SOP 89-2, *Reports on Audited Financial Statements of Investment Companies.*]

* In February, 1989, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows From Certain Securities Held for Resale.* That statement amends FASB Statement No. 95, *Statement of Cash Flows,* to exempt certain investment companies that meet specified criteria from the requirement to provide a statement of cash flows.

AAM Section 11,000

QUALITY CONTROL FORMS AND AIDS

These sample quality control documents are presented for illustrative purposes only. They are intended as an aid for users of this Manual who may want points of departure when establishing their own quality control policies and procedures. These illustrations are neither all inclusive nor are they prescribed minimums. Auditors and accountants should rely on professional standards and their individual professional judgment in determining what may be needed in the circumstances.

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AAM Section 11,100
Quality Control—General

AICPA Requirements

.01 Article VI—*Scope and Nature of Services*—of the AICPA's *Principles of Professional Conduct* (ET section 57), requires that members in the practice of public accounting "practice in firms that have in place internal quality control procedures to ensure that services are competently delivered and adequately supervised."

.02 To provide itself with reasonable assurance of meeting its responsibility to provide professional services that conform with professional standards, a firm shall have a system of quality control. Statement on Quality Control Standards, *System of Quality Control for a CPA Firm,* (the statement) describes the elements of a quality control system that should be applied to all accounting, auditing, and review services for which professional standards have been established. This statement is included in its entirety in QC section 10 of the *AICPA Professional Standards* and is briefly described below.

Quality Control System

.03 A system of quality control for a firm encompasses the firm's organization structure and the policies adopted and procedures established to provide the firm with reasonable assurance of conforming with professional standards. The system of quality control should be appropriately comprehensive and suitably designed in relation to the firm's organizational structure, its policies, and the nature of its practice (QC section 10.03).

.04 The nature and extent of a firm's quality control policies and procedures depend on a number of factors, such as its size, the nature of its practice, its organization and appropriate cost-benefit considerations (QC section 10.06).

.05 In developing a quality control system, a firm shall consider each of the nine elements of quality control discussed below, to the extent applicable to its practice.

a. **Independence.** The firm should be assured that persons at all levels maintain independence to the extent required by the rules of conduct of the AICPA.

   Forms which may assist you are:

Section	Form Name
11,500.01	Independence Checklist for Employees
11,500.02	Independence and Representation Checklist for Other Auditors

b. **Assigning Personnel to Engagements.** The firm should be assured that work will be performed by persons having the degree of technical training and proficiency required in the circumstances.

   Forms which may assist you are:

Section	Form Name
11,500.03	Scheduling Request
11,500.04	History of Staff Assignments
11,500.05	Client History of Personnel Assigned
11,500.06	Scheduling Master Plan

c. **Consultation.** The firm should be assured personnel will seek assistance, to the extent required, from persons having appropriate levels of knowledge, competence, judgment, and authority.

   Forms which may assist you are:

Section	Form Name
11,500.07	Consultation Log
11,500.08	Consultation Worksheet

d. **Supervision.** The firm should be assured that work at all organizational levels is supervised to ascertain that the work performed meets the firm's standards of quality.

Forms which may assist you are:

Section	Form Name
3170.01-.02	Audit Time Budget
3170.03-.04	Audit Time Analysis
3170.05	Weekly Progress Report
3165.01-.12	Illustrative Planning Checklist
3175.01-.12	Sample Engagement Letters
2200.24	Illustrative Engagement Letter for a Compilation
2200.25	Illustrative Engagement Letter for a Review
5400.010-.190	Illustrative Audit Programs for Corporations
9100.01-.24	Supervision and Review Procedures
11,500.04	History of Staff Assignments

e. **Hiring.** The firm should be assured that those employed possess the appropriate characteristics to enable them to perform competently.

Forms which may assist you are:

Section	Form Name
11,500.09	Pre-Employment Application
11,500.10	Interview Report

f. **Professional Development.** The firm should be assured that personnel will have the knowledge required to enable them to fulfill responsibilities assigned and to comply with applicable (state) Board of Accountancy requirements.

Forms which may assist you are:

Section	Form Name
11,500.11	Record of Professional Development
11,500.12	Professional Development Summary (in hours)
11,500.13	Professional Development Summary (in dollars)

g. **Advancement.** The firm should be assured that those selected for advancement will have the qualifications necessary for fulfillment of the responsibilities they will be called on to assume.

Forms which may assist you are:

Section	Form Name
11,500.14	Performance Evaluation
11,500.15	Job Evaluation Report
11,500.16	Knowledge and Skill Form
11,500.17	Employee Annual Performance Appraisal

h. **Acceptance and Continuation of Clients.** The firm should be assured that the decision to accept or continue a client is in the best interest of the firm as well as the client.

Forms which may assist you are:

Section	Form Name
11,500.18	New Client Acceptance Checklist
11,500.19	Client Evaluation Questionnaire
2200.22	Client Acceptance Form
2200.23	Client Information Form

i. **Inspection.** The firm should be assured that the procedures relating to other elements of quality control are being effectively performed.

Forms which may assist you are:

Section	Form Name
11,500.20	Summary Inspection Report
11,500.21	Inspection of Compliance With Policies and Procedures Relating to Elements of Quality Control

The elements are interrelated. For example, a firm's hiring practices affect its policies as to training, training affects policies as to promotion, etc. The system should be designed to function together to maintain a firm's quality. (This section does not specifically cover services for OCBOA, Agreed-Upon Procedures, Prospective Financial Statements, Internal Control Reports or Attest Engagements. A firm may want to develop alternative Quality Control checklists for these engagements.)

.06 Although firms are not required to have a formal quality control document, many firms find preparation and dissemination to their staff of such a document useful. The sample quality control documents for local CPA firms and sole practitioners presented in the following sections have been prepared using the information contained in Statement on Quality Control Standards, *System of Quality Control for a CPA Firm,* the interpretations of this statement, and the guide entitled, "Quality Control Policies and Procedures for CPA Firms," which was prepared by the Quality Control Review Committee for use in establishing guidance for the implementation of this statement. The publications are included in the Quality Control section of *Professional Standards,* volume 2.

[The next page is 11,201.]

AAM Section 11,200
Sample Quality Control Document for a Multi-Partner Local CPA Firm

.01 Firm Background Information

Our firm has _____ partners, nine professional staff, and four clerical staff—a total of _____ people. One partner has been designated as the executive partner and another as administrative partner. (A copy of our organization chart follows on the next page.)

Our executive partner founded the firm in 19XX, and our growth has been derived entirely from internal expansion. All of the other partners joined the firm as staff assistants and were promoted to partner level.

Our objective is to provide quality accounting, auditing, tax, and management advisory services to our clients.[1] To this end we expect to limit our practice to those clients we can properly serve. We intend to further develop expertise that will enable us to increase the number of clients that are municipalities and auto dealerships. Therefore, we plan to hire and train professional personnel who will be able to function to meet these goals.

We expect our growth to continue to be internal and to be limited to our present geographic practice area; a community we have served for nearly 35 years. We hope to retain our local identity and personal relationship with clients that are the foundations of our practice.

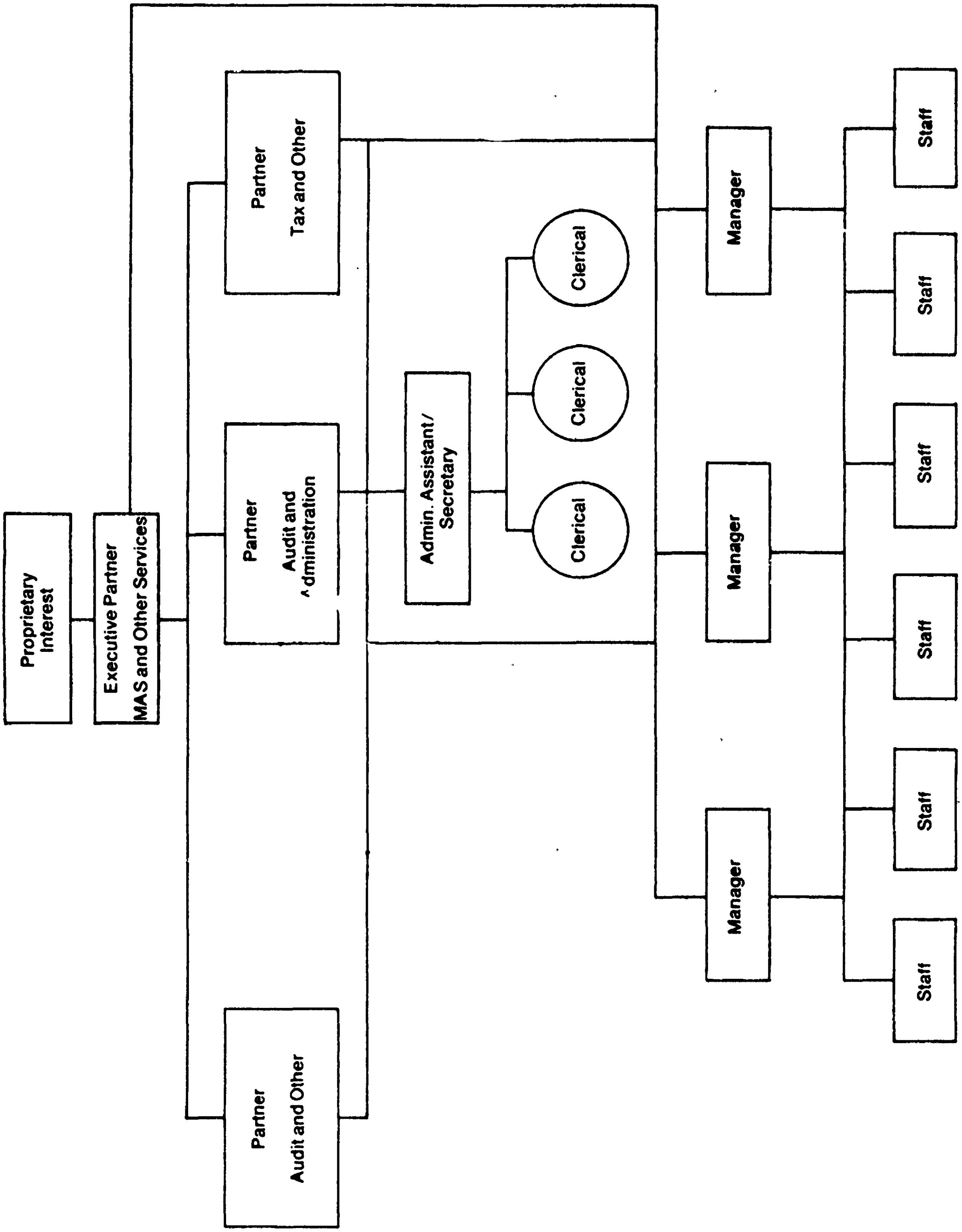
We hope to be a firm that is enjoyable and rewarding to work for. We intend to continue our involvement in and contribution to community and professional activities and organizations.

Our practice breakdown is as follows:

Auditing	33%
Reviews	10
Compilations	15
Taxes	25
Management advisory services	9
Other accounting services	8
	100%

[1] Additional considerations for establishing a firm's stated objectives are discussed in AAM section 11,200.12.

Organization Chart



Our practice is conducted from one office and is basically a general practice composed of the following types of clients:

Audit engagements
  Publicly held corporations
  Manufacturing companies
  Retail establishments
  Auto dealerships
  Municipalities
Unaudited statement engagements
Other accounting services

For the benefit of our professional personnel, an accounting and auditing manual and a personnel manual are maintained. Both manuals are referred to in this document and are, in effect, an integral part of our quality control system.

November 1, 19XX

.02 Independence

1. **All personnel are required to adhere to the independence rules, regulations, interpretations, and rulings of the AICPA, (state) CPA Society, (state) Board of Accountancy, state statutes, and for applicable engagements, the Securities and Exchange Commission and other regulatory agencies under which we practice.**

   a. The executive partner is responsible for resolving questions relating to independence matters and is available to provide guidance when required.

   b. The executive partner communicates with the AICPA and/or the (state) CPA Society for assistance in resolving independence questions that are not satisfactorily resolved within the firm. (See AAM section 11,500.07 for an example of a log which can be utilized to document all communication with parties outside the firm, also see AAM section 11,500.08 for a Consultation Worksheet, which can be used to document the subject matter as well as the response from the consultant.)

   c. A memo documenting the resolution of independence questions is prepared and retained by the executive partner. The other firm personnel involved in the questions review and initial the memo.

2. **Policies and procedures relating to independence are communicated to all personnel.**

   a. The personnel manual is used to inform personnel of the firm's independence policies and procedures and advise them that they are expected to be familiar with these policies and procedures. Rulings and interpretations of the AICPA, (state) CPA Society, (state) Board of Accountancy, state statutes, the Securities and Exchange Commission and other regulatory agencies under which we practice are referred to in the personnel manual.

   b. Independence of mental attitude is emphasized during training sessions and in the supervision and review of engagements.

   c. Our client list, which is periodically updated, is reviewed by all partners and professional employees to ensure that they are aware of those entities to which our independence policies apply. The executive partner is responsible for maintenance and distribution of the list.

   d. The firm's library contains professional, regulatory, and firm literature relating to independence matters.[2]

[2] The appropriate information may be found in *AICPA Professional Standards,* volume 2, in regulation S-X and Accounting Series Releases of the Securities and Exchange Commission, rulings and interpretations of the state CPA societies, the state boards of accountancy, and state statutes.

3. **Independence is confirmed when another firm is engaged to perform a segment of an engagement for which we are the principal auditor.**

    a. The form and content of the independence representation that is to be obtained from a firm that has been engaged to perform segments of an engagement is part of the firm's accounting and auditing manual. (See AAM section 11,500.02.)

    b. An annual representation of independence should be obtained from an affiliate or associate firm on a repeat engagement.

4. **Compliance with policies and procedures relating to independence is monitored.**

    a. Confirmations are obtained annually (See AAM section 11,500.01 for an example of an Independence Checklist for Employees.) by the administrative partner from personnel and upon employment from newly hired personnel confirming that—

        (i) They are familiar with our firm's independence policies and procedures.

        (ii) Prohibited investments are not held and were not held during the period.

        (iii) Prohibited relationships do not exist.

        (iv) Transactions prohibited by the firm have not occurred.

    b. The executive partner is responsible for the resolution of exceptions to the firm's independence policies and procedures.

    c. The executive partner designates a partner to perform an annual review each July of the independence compliance files for completeness and the firm's independence policies and procedures for compliance with professional standards. A report of findings is presented to all the partners.

    d. Accounts receivable that are past due are reviewed monthly by the executive partner to ascertain whether any outstanding amounts take on some of the characteristics of loans and may, therefore, impair the firm's independence.

.03 Assigning Personnel to Engagements

1. **Our firm's approach to assigning personnel includes the planning of overall firm needs and the measures employed to achieve a balance of engagement manpower requirements, personnel skills, individual development, and utilization.**

    a. On a quarterly basis all partners submit to the administrative partner a projection containing anticipated manpower requirements for engagements during the coming quarter for which they have client responsibilities. (See AAM section 11,500.03 for an example of a form which may be used for this purpose.) Such projections are detailed as to number and classification of individuals required and are supported by preliminary engagement time estimates. The administrative partner prepares a summary schedule of assignments to be made for approval by the partners.

    b. For every engagement where the anticipated time exceeds ten man-days, a time budget is normally prepared under the direction of the engagement partner at least a month prior to the scheduled commencement of field work. Time budgets for smaller engagements are prepared as considered necessary by the engagement partners. The budgets provide detail as to appropriate staff level and time required by function such as cash, accounts receivable, inventory, and so forth.

    c. The engagement partner considers the following factors to achieve a balance of engagement manpower requirements, personnel skills, individual development, and utilization:

(i) Engagement size and complexity

(ii) Personnel availability

(iii) Special expertise required

(iv) Timing of the work to be performed

(v) Continuity and periodic rotation of personnel

(vi) Opportunities for on-the-job training

2. **The administrative partner is responsible for assigning personnel to engagements.**

   a. Before the assignment of a professional employee to an engagement, the following criteria are considered:

      (i) Staffing and timing requirements of the specific engagement.

      (ii) Evaluation of the qualifications of personnel as to experience, position, background, and any special expertise possessed. (See AAM section 11,500.04.)

      (iii) The planned extent of supervision and involvement by managers and partners.

      (iv) Projected time availability of individuals assigned.

      (v) Situations where possible independence problems and conflicts of interest may exist, such as assignment of personnel to engagements for clients who are former employers or employers of certain kin.

   b. The administrative partner attempts to achieve a balance between the need for continuity and for periodic rotation of personnel.

3. **The engagement partner approves the scheduling and staffing of the engagement.**

   a. The names of personnel assigned to an engagement are submitted to the engagement partner for approval.

   b. The engagement partner considers the experience and training of the assigned personnel in relation to complexity or other engagement requirements, and the extent of supervision to be provided.

   c. Unresolved assignment conflicts between an engagement partner and the administrative partner are resolved by the executive partner.

.04 Consultation

1. **Areas and specialized situations where consultation is required are identified, and personnel are encouraged to consult with or use authoritative sources on complex or unusual matters.**

   a. All personnel are advised of our firm's consultation policies and procedures. These policies and procedures are incorporated into the firm's accounting and auditing manual.

   b. A listing of certain areas or specialized situations, which because of the nature or complexity of the subject have been identified as requiring consultation, is updated semiannually by the administrative partner for inclusion in the accounting and auditing manual. The following areas and situations receive special consideration in preparing the list:

      (i) Application of newly issued technical pronouncements.

      (ii) Industries with special accounting, auditing, or reporting requirements.

(iii) Emerging practice problems.

(iv) Choices among alternative generally accepted accounting principles when an accounting change is to be made.

(v) Filing requirements of regulatory agencies.

c. A technical reference library is maintained to assist personnel in resolving practice problems. The administrative partner is charged with the responsibility of reviewing semiannually the library contents and making necessary additions.

d. Supervisory personnel are encouraged to seek advice from partners and managers the firm has designated as specialists in particular areas when confronted with a situation in the specialist's area of expertise.

e. When expertise is not available within the firm, a practice question or problem is referred by the engagement partner to the Technical Information Division of the AICPA or the (state) CPA Society established to handle technical inquiries.

f. We maintain a consultation agreement with the local office of (firm name) CPAs to provide our firm with additional expertise. Inquiries to that firm are channeled through the administrative partner.

g. The results of outside consultation are reviewed by the engagement partner and the executive partner before a decision is reached on the matter in question.

h. An example of a log which can be utilized to maintain a listing of consultations is shown in AAM section 11,500.07. This log can be put in the workpapers to document consultants utilized on the engagement as well as to maintain control for follow-up documentation from the specific consultant used.

i. An example of a worksheet which can be used to document the consultations with specialists is shown in AAM section 11,500.08.

2. **Specific individuals are designated as having specialized experience and expertise in certain technical areas. These individuals are available for consultation to all personnel.**

a. A listing of firm designated specialists together with their particular expertise is updated semiannually and included in the accounting and auditing manual.

b. The following procedures are used to resolve differences of opinion on practice problems:

(i) Differences of opinion between a professional employee and an engagement partner are brought before the appropriate designated specialist.

(ii) If the specialist agrees with the engagement partner, the matter is considered resolved.

(iii) If the specialist disagrees with the engagement partner and they are unable to agree on an appropriate resolution, the executive partner is consulted.

c. The engagement partner is responsible for the preparation of a memorandum documenting the considerations involved in the resolution of differences of opinion. The original of the memorandum is filed with the engagement working papers and a reference copy without identification of the client is placed in the subject file maintained in the library. Any party to the discussion who disagrees with the conclusion has the option of preparing a memorandum and filing it with the working papers.

3. **In situations where firm policy requires consultation with specialists, a summary of the consultation conclusions and the reasons for the conclusions is required.**

a. The accounting and auditing manual is used to inform personnel of the extent of documentation required and the responsibility for its preparation. (See AAM section 11,500.07)

b. Consultation worksheets (see AAM section 11,500.08) are filed with the engagement working papers, and a copy is placed in the subject file maintained in the library under the supervision of the administrative partner. The subject file is maintained in the event that similar questions arise in connection with the same topics.

.05 Supervision

1. **All engagements are adequately planned by persons knowledgeable about the client and/or the type of engagement.** (For additional information on planning, review AAM section 3000.)

   a. For all annual recurring audit and accounting engagements where the anticipated manpower requirement is in excess of ten man-days, the in-charge accountant or manager reviews with the engagement partner the following documents from the prior year's files (as applicable) to determine if modifications are appropriate:

   (i) Engagement letter

   (ii) Time budget compared with actual time expended

   (iii) Evaluation of the internal control structure

   (iv) Audit or work program

   (v) Engagement memorandums

   (vi) Financial statements and accountant's report

   (vii) Management letters

   (viii) Planning memorandum

   b. On all engagements in excess of ten man-days, new engagements, and special engagements, the in-charge accountant or manager submits to the engagement partner the following, where applicable, for his written approval:

   (i) Engagement letter

   (ii) Time budget

   (iii) Preliminary evaluation of the internal control structure

   (iv) Audit or work program

   (v) A memorandum stating the manpower requirements (including the need for specialized knowledge), current economic conditions affecting the client or its industry, and any other special problems that may have an impact on the conduct of the engagement

   (vi) Planning memorandum

2. **Procedures are provided for maintaining the firm's standards of quality for the work performed.**

   a. Depending upon each individual's background in relationship to his assignment, varying degrees of supervision are provided by proper engagement staffing. (See AAM section 11,500.04.)

   b. Each staff member receives an accounting and auditing manual upon joining the firm and is responsible for the proper filing of updates as they are issued.

c. Differences of opinion among staff members working on an engagement are brought to the attention of the engagement partner. If the partner agrees with the senior party in the dispute, the matter is considered resolved. If no resolution is made, the executive partner is consulted. Any party to the discussion who disagrees with the conclusion has the option of preparing a memorandum and filing it with the working papers.

3. **All engagement working papers and reports are reviewed by appropriate supervisory personnel prior to issuance of the report.** (For additional information on Supervision, review AAM section 9000.)

a. The in-charge accountant and/or manager reviews and initials all working papers he did not prepare (including those prepared by a partner). The engagement partner reviews the overall engagement (initialing all working papers not reviewed by a manager and working papers dealing with difficult and complex subjects) including financial statements and accountant's report, and discusses with the in-charge accountant or manager any critical audit areas and unusual accounting matters encountered during the course of the engagement. This discussion is documented by a memorandum when appropriate.

b. In certain circumstances (as enumerated at AAM section 11,200.09 item 1(d)) prior to the issuance of the financial statements and the auditor's report thereon, a second partner not otherwise associated with the engagement evaluates the appropriateness of financial statement disclosures and the auditor's report in relation to the material discussed in the engagement partner's memorandum.

.06 Hiring

1. **The firm maintains a program designed to obtain qualified personnel by planning for personnel needs, establishing hiring objectives, and setting qualifications for those involved in the hiring function.**

a. The administrative partner and the executive partner plan (at least annually) the firm's long-range personnel objectives. Current clientele, anticipated growth, personnel turnover, individual advancement, and retirement are among the factors considered. This plan considers the number and qualifications of personnel as well as the sources and methods for obtaining personnel who meet the requirements and guidelines set by the firm.

b. The administrative partner is responsible for employment decisions.

2. **Our firm has established qualifications and guidelines for evaluating potential hirees at each professional level.** (See AAM section 11,500.09 for an example of a Pre-Employment Application which can be used to determine the individual's qualifications and AAM section 11,500.10 for an example of an Interview Report which can be used to document the interviewer's comments about individuals interviewed for positions within the firm.)

a. Our firm seeks to employ individuals who possess high levels of intelligence, integrity, honesty, motivation, and aptitude for the profession.

b. Our firm normally employs college and business college graduates with a concentration in accounting as full-time permanent members of our professional and paraprofessional staff.

c. Newly employed staff members are from the top half of their college class, unless other factors such as personal achievements, work experience, and personal interests indicate the likelihood of adequate professional development.

d. Our firm requires that a professional staff applicant have the academic background that will enable him to meet the academic requirements to sit for the CPA examination as administered by the (state) Board of Accountancy.

e. The approval of the executive partner is required before making an employment offer in atypical situations, such as hiring relatives of personnel or clients, rehiring former employees, or hiring clients' employees.

f. The background of new employees is appropriately investigated to reasonably assure hiring persons with acceptable qualifications, by obtaining completed application forms, college transcripts, and personal references.

g. Applicants for positions above entry level are interviewed and approved by the executive partner in addition to the administrative partner before an employment decision is made.

3. **Applicants and new personnel are informed of the firm's policies and procedures relevant to them.**

a. The firm's personnel policies and procedures relevant to applicants are communicated to them before offers of employment are extended.

b. The administrative partner maintains and distributes to all personnel a personnel manual describing policies and procedures.

c. The administrative partner discusses the firm's personnel policies and procedures with new employees.

.07 Professional Development

1. **Guidelines and requirements have been established for the firm's professional development program and are communicated to all personnel.**

a. The administrative partner is responsible for the formulation and implementation of firm policy regarding the guidelines and requirements for the firm's professional development programs.

b. As part of their orientation, newly employed personnel are informed of their professional responsibilities and opportunities by the administrative partner.

c. Newly employed personnel with limited experience are sent to introductory level training sessions of the AICPA or the (state) CPA Society during their first year of employment with our firm.

d. Each partner and professional employee is required to complete a minimum of 40 hours of continuing professional education each year. (Firms should determine the specific requirements of their State Board of Accountancy.) Personnel complete the record of professional development form and forward it to the administrative partner. (See AAM section 11,500.11.) The administrative partner is responsible for having the personnel files of each partner and professional employee updated to include a current record of hours of professional development completed. (See AAM section 11,500.12—.13.) The types of programs qualifying for the fulfillment of the 40-hour requirement include—

(i) Continuing professional education programs of the AICPA and the (state) Society of CPAs. This includes both sessions attended and cassette/workbook or workbook programs, as long as there is written evidence of completion.

(ii) College courses related to the profession.

e. Personnel are reimbursed for membership dues paid to the AICPA, the (state) Society of CPAs and our local chapter of the state society.

f. Personnel are encouraged to serve on state society or AICPA committees, write articles for professional publications, serve as discussion leaders at professional development seminars, give speeches, and so forth.

g. The executive partner annually reviews the firm's professional development program (including personnel participation records) to determine whether it is adequately meeting the firm's needs, providing for the professional growth of individuals, and meeting mandatory continuing education requirements. An annual report is made to the partners.

2. Information about current developments in professional technical standards and materials containing the firm's technical policies and procedures are made available to personnel. Personnel are encouraged to engage in self-development activities.

a. It is the responsibility of the administrative partner to distribute information about current developments in accounting and auditing to all personnel who do not receive them directly. This distribution includes statements and interpretations issued by the Financial Accounting Standards Board, Governmental Accounting Standards Board, the AICPA Auditing Standards Board, and other AICPA technical committees.

b. Pronouncements relating to areas of specific interest, such as those issued by the Securities and Exchange Commission, Internal Revenue Service, and other regulatory agencies are distributed by the appropriate specialist to persons who have responsibilities in such areas.

c. The administrative partner, as the firm's lead technician, is responsible for maintaining an accounting and auditing manual containing firm policies and procedures on technical matters. Updates are prepared and issued to the staff as new developments and conditions arise.

d. The firm does not, at present, conduct formal in-house training programs other than in specialized areas. However, from time to time personnel participate in the training programs of the AICPA and (firm name) CPAs.

e. A library of staff training cassette/workbook programs published by the AICPA and (state) Society of CPAs is maintained by the administrative partner for self-study and reference purposes and is available to all personnel.

3. The firm provides programs to fill its needs for personnel with expertise in specialized areas and industries.

a. The administrative partner is responsible for arranging in-house programs on SEC matters, cost accounting, and municipal accounting for personnel involved in these areas.

b. Individuals designated as having specialized experience and expertise are encouraged to maintain their proficiency by joining appropriate professional associations and attending external professional education programs.

c. The firm will pay for memberships in organizations concerned with specialized areas or industries in which the firm is engaged or intends to become engaged.

d. The administrative partner is responsible for maintaining technical literature on specialized areas and industries.

4. The firm recognizes that on-the-job training accounts for a significant part of professional development.

a. Personnel with in-charge responsibility on engagements—

(i) Discuss with assistants the relationship of the work they are performing to the engagement as a whole.

(ii) Permit assistants, when practicable, to become involved in areas of the engagement other than those previously assigned.

(iii) Explain to assistants the reasons for any additional work requirements discovered through the review process.

b. Personnel are evaluated in part on their effectiveness to properly train and develop subordinates.

c. The administrative partner monitors assignments to determine that personnel are—

(i) Fulfilling, where applicable, the experience requirement of the (state) Board of Accountancy.

(ii) Gaining experience in various areas of engagements and varied industries.

(iii) Working under different supervisory personnel.

.08 Advancement

1. **Our firm has established qualifications deemed necessary for the various levels of responsibility within the firm.**

a. The levels of responsibility that are inherent in the various staff classifications are clearly defined. Our firm has provided for the following staff classifications.[3]

(i) Manager

(ii) In-charge accountant

(iii) Staff assistant

b. The criteria which are considered in evaluating individual performance and expected proficiency are enumerated in our staff classification guidelines contained in the personnel manual.

c. Our firm's personnel manual provides the staff with information regarding the firm's advancement policies and procedures. The administrative partner issues updates from time to time to reflect changes made by the partnership in the policies and procedures.

2. **The performance of our personnel is continuously evaluated, and personnel are periodically advised of their progress. Personnel files are maintained containing documentation relating to the evaluation process.**

a. Professional employees assigned to an engagement for a period in excess of five days must be evaluated by their immediate superior on the engagement by use of an evaluation form. (See AAM section 11,500.14—.15 for examples of Evaluation Forms, which may be used for periodic evaluation of staff members. The differences in the forms relate to the amount of time spent on a particular engagement. For example, if a staff member spends 40 or more hours on an engagement a more thorough evaluation can usually be performed (AAM section 11,500.14). AAM section 11,500.16 would be utilized to evaluate the management skills of the individual being evaluated and therefore does not include specific duties relating to the assignment of work performed.) These evaluation forms are reviewed with the employee at the end of the engagement and are approved by the engagement partner.

b. Personnel are assigned to engagements in a manner that assures they will be reviewed by several people during the course of a year.

c. Personnel with the responsibility for the preparation of evaluations are counseled (at least annually) by the administrative partner to ensure that they understand the firm's objectives.

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[3] The description of the firm's professional levels, with the responsibilities for each level and the general length of time required for advancement to the next position, can be found in AAM section 11,200.11.

d. All professional employees receive an evaluation of their performance at least once a year. Such counseling interviews are conducted by the administrative partner. These evaluations summarize the evaluations received on engagements during the year. The individual's progress, strengths, weaknesses, future objectives, and the firm's future objectives are among the items discussed. The interviews are documented in each individual's personnel file.

e. Annually, each partner completes a partner evaluation form evaluating each of the partners, including himself. The completed forms are submitted to the executive partner who summarizes and reviews them with each partner.

f. The executive partner or his designee reviews (each August) the system of personnel evaluation and counseling to ascertain that—

(i) Procedures for evaluation and documentation are being followed on a timely basis.

(ii) Requirements established for advancement are being met.

(iii) Personnel decisions are consistent with evaluations.

(iv) Recognition is given to outstanding performance.

At the completion of the review, a report is made to the partners.

3. **Responsibility for making advancement decisions is assigned to specific individuals.**

a. The administrative partner is responsible for making advancement and termination recommendations, conducting the evaluation interviews, documenting the results of the interviews, and maintaining appropriate records.

b. The partners evaluate the above data and, after giving appropriate recognition to the quality of the work performed, make advancement decisions. The executive partner has the ultimate responsibility for making advancement decisions.

c. The executive partner studies the firm's advancement experience annually to ascertain whether individuals meeting stated criteria are assigned increased degrees of responsibility. A report is made to the partners. This report includes the executive partner's opinion of the capabilities and progress of the staff.

.09 Acceptance and Continuance of Clients

1. **Our firm has established procedures for evaluation of prospective clients and for their acceptance as clients.** (See AAM section 11,500.18 for a New Client Acceptance Checklist, which can be used for prospective clients.)

a. Available financial information regarding the prospective client, such as annual reports, interim financial statements, reports to regulatory agencies, and income tax returns is obtained and reviewed. Registration statements and 10-K forms are obtained for public companies.

b. Inquiries about potential clients are made to bankers, attorneys, credit services, and others having business relationships with the company.

c. Predecessor auditors (if applicable) are contacted and inquiries are made in accordance with generally accepted auditing standards.

d. Consideration is given to circumstances that would cause the firm to regard the engagement as one requiring special attention or presenting unusual risks. These circumstances include—

(i) Audits of publicly held corporations

(ii) Audits where the expected man-hour requirement exceeds 300 hours

(iii) Audits of firms operating in high-risk industries, such as those industries where it is difficult to establish an adequate internal control structure or those industries whose operations are especially sensitive to general economic conditions

(iv) Audits of firms in the development stage

(v) Audits of firms in serious financial difficulty

(vi) Any of the conditions enumerated in 2(a)(iii)

e. The firm's independence and ability to adequately serve a potential client are evaluated prior to acceptance. In evaluating the firm's ability, consideration is given to the requirements for technical skills, knowledge of the industry, and availability of qualified personnel.

f. A review is made to ensure that acceptance of the client would not violate applicable regulatory agency requirements and the code of professional conduct of the AICPA and/or the (state) CPA Society.

g. Procedures for acceptance of a new engagement are as follows:

(i) The engagement partner assembles the information and evaluates all matters described in the previous paragraphs.

(ii) For all audit engagements, or engagements described in paragraph (d) above, the acceptance is to be approved in writing by the engagement partner and the executive partner.

(iii) All other engagements are to be approved in writing by the engagement partner and the administrative partner.

h. The administrative partner is responsible for administering the procedures for acceptance of clients. The executive partner performs an annual review for compliance with the firm's policies and procedures for acceptance of clients and makes a report to the partners.

2. **Clients are evaluated at the end of specific periods or upon the occurrence of certain events to determine whether the relationship should be continued.** (See AAM section 11,200.19 for a Client Evaluation Questionnaire which can be used for evaluating existing clients.)

a. Reevaluations are made of existing clients—

(i) Annually, if any of the conditions mentioned in 1(d) above exist.

(ii) Every three years if none of the conditions mentioned in 1(d) above exist.

(iii) If there is a significant change in one or more of the following:

- Management
- Directors
- Ownership
- Legal counsel
- Financial condition
- Litigation status
- Nature of client's business
- Scope of the auditor's work

(iv) Upon the emergence of conditions that would have caused the firm to reject a client had such conditions existed at the time of the initial acceptance.

b. The administrative partner is responsible for evaluating the information obtained, making continuance recommendations, and administering firm procedures for continuance of clients. If the administrative partner recommends discontinuance or if any of the conditions enumerated in 2(a)(iii) above or (iv) above exist, all partners participate in the continuance decision.

c. The executive partner performs an annual review to test for compliance with the firm's policies and procedures for continuance of clients and makes a report to the partners.

.10 Inspection

1. **The firm conducts an inspection program regarding its quality control policies and procedures.** (See AAM section 11,500.20 for a Summary Inspection Report, which can be used to document the results of a firm's yearly quality review inspection and AAM section 11,500.21 for an Inspection of Compliance with Policies and Procedures Relating to Elements of Quality Control.)

   a. Each year a partner and a manager not otherwise directly involved in firm administration are appointed by the executive partner as an inspection team to evaluate the firm's quality control policies and procedures for compliance with professional standards.

   b. The appointed partner and manager obtain reasonable assurance that quality control policies and procedures are being complied with by—

      (i) Inquiring of persons responsible for a function or activity.

      (ii) Reviewing selected administrative and personnel files.

      (iii) Reviewing selected engagement working paper files and reports (described below).

      (iv) Reviewing other evidential matter.

   c. A sample of engagements is selected annually from each partner's and manager's client listing and is given an in-depth review by the inspection team. The administrative partner reviews engagements of the partner and manager involved in the inspection process to ensure that a representative sample of engagements from all partners and managers has been selected. The working papers and reports are reviewed for compliance with professional standards, including generally accepted auditing standards, generally accepted accounting principles, and the firm's quality control policies and procedures.

   d. The executive partner annually selects a representative report to be submitted for review to the practice review committee of the (state) Society and/or the AICPA.

   e. Every third year the firm has a quality review. The executive partner is responsible for scheduling this review. This review takes the place of the firm's annual inspection.

2. **Provision is made for reporting inspection findings to the appropriate management levels and for monitoring actions taken or planned.**

   a. The results of engagement reviews are discussed with the supervisory personnel responsible for the engagement.

   b. Inspection findings and recommendations are reported to the partners by the inspection team together with corrective actions taken or planned. A memo outlining the findings and recommendations is prepared by the inspection team and is retained by the executive partner.

c. The executive partner has the responsibility to determine that planned corrective actions were taken and to report the extent of compliance to all the partners.

.11 Description of the Firm's Professional Levels

Level	*Approximate Time Frame*
Staff Assistant	
Level 1	First year (0 to 1)
Level 2	Second year (1 to 2)
In-Charge Accountant	Third, fourth, fifth (3 to 5)
Audit Manager	Sixth through tenth year (6 to 10)
Partner	After the tenth year

Staff Assistant (Level 1). A Level 1 staff assistant is expected to—

- Work on portions of audit and accounting engagements.
- Become familiar with the contents of the firm manuals.
- Know the rules, regulations, and code of conduct of the AICPA and the (state) Society of CPAs.
- Be familiar with the pronouncements of the Financial Accounting Standards Board (FASB) and the AICPA, such as the Statements on Auditing Standards (SASs) and Accounting Principles Board Opinions (APBs).
- Progress professionally by working toward passing the CPA examination as soon as possible.

Staff Assistant (Level 2). A Level 2 staff assistant should be able to—

- Assume full responsibility under supervision for small accounting engagements involving unaudited financial statements.
- Work on more involved portions of large audit and accounting engagements.
- Prepare financial statements.

In-Charge Accountant. An in-charge accountant is expected to—

- Assume full responsibility for small and medium-size audit engagements requiring the services of one or two people and large accounting engagements involving unaudited financial statements.
- Work on (and research) assignments involving "theory" and such "conceptual" areas as materiality and interrelationships of accounts.
- Review and analyze internal control.
- Prepare audit programs and time budgets.
- Prepare management letters.
- Train and supervise the staff assistants assigned to the engagement.
- Recognize, in advance, the possible problem areas of an engagement.
- Pass the CPA examination, if not already certified.

Manager. A manager is a CPA and is expected to—

- Assume full responsibility for large audit assignments falling within his expertise.

- Supervise the assignment of duties to, and the training of, personnel assigned to the engagement.
- Supervise a number of engagements at one time.
- In connection with engagements, be responsible for personnel scheduling, compliance with due dates, and monitoring time budgets.
- Adequately review all working papers and the completed reports to ascertain that both meet firm standards.
- Resolve all problems prior to the submission of the report for final partner review.
- Communicate firm policies and technical information to accounting and auditing personnel through individual or group meetings.
- Motivate and assist staff in their professional development.
- Represent the firm in professional and service organizations.
- Develop the firm's reputation and his own through conducting seminars, making speeches, and the like.
- Assist partners with practice development and practice management.

.12 Stated Objectives of Firm (Philosophy)

A particular firm's stated objectives may include items such as the following:

1. Concern for the general public interest.
2. Concern for the financial well-being of clients.
3. Reinvestment of the firm's profits in the training and advancement of the firm's partners and staff.
4. Growth plans for the firm, including opening of branch offices, annual billings, and staff size.
5. Development of specialties such as auditing governmental units or concentration in particular fields—agriculture, retail, and so forth.
6. Development of other services, such as a computer data processing center.
7. Centralization (or decentralization) of authority for issuance of reports.
8. Degree of operating autonomy for individual practice offices.
9. Extent of autonomy for partners.
10. Pattern for firm growth—internal growth through acquisitions of clients and growing apace with them or growth through mergers with other accounting firms.

[The next page is 11,301.]

AAM Section 11,300

Sample Quality Control Document for a Sole Practitioner CPA Firm Without Full-Time Staff

.01 Firm Background Information

My firm was founded in 19XX after I had gained several years' experience with a local CPA firm. A secretary and a student from the local university are employed on a part-time basis during the busy season.

My objective is to provide quality service in accounting, auditing, income tax, and financial advisory capacities to small businesses in my community. I do not serve publicly held companies, nor do I plan to do so. It is anticipated that the firm's future growth will be through expanded service to present clients and the addition of new clients.[1] I intend to hire and train personnel as needed.

My practice is conducted from one office and consists of five audit engagements, for which we are the sole auditors, twelve unaudited financial statement engagements, and fifteen clients for which my firm provides other accounting services.

May 31, 19XX

.02 Independence

Any part-time staff and I are required to adhere to the independence rules, regulations, interpretations, and rulings of the AICPA, (state) CPA Society, (state) Board of Accountancy, and state statutes.

a. I communicate with the AICPA and/or the (state) CPA Society for assistance, if needed, in resolving independence questions. (See AAM section 11,500.07 for an example of a log which can be utilized to document all communication with parties outside the firm. Also, see AAM section 11,500.08 for a Consultation Worksheet, which can be used to document the subject matter as well as the response from the consultant.

b. My part-time staff complete an independence checklist for employees when they are hired. The purpose of the checklist is to determine the part-time staff member's independence and to document the same.

c. A memorandum documenting the resolution of independence questions is prepared and retained. My part-time employee reviews and initials the memorandum if the question relates to his independence.

d. Accounts receivable that are past due are reviewed monthly to ascertain whether any outstanding amounts take on some of the characteristics of loans and may, therefore, impair the firm's independence.

e. Our library contains professional, regulatory, and firm literature relating to independence matters.[2]

.03 Assigning Personnel to Engagements

Assignment of personnel includes the planning of overall firm needs and the measures employed to achieve a balance of engagement manpower requirements, personnel skills, individual development, and utilization.

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[1] Additional considerations for establishing a firm's stated objectives are discussed in AAM section 11,300.11.

[2] The appropriate information may be found in *AICPA Professional Standards,* volume 2, and in rulings and interpretations of the state CPA societies, the state boards of accountancy, and state statutes.

On an annual basis, normally in October of each year, I develop a projection of anticipated manpower requirements to determine if I will need additional staff during the coming year. This is performed by utilizing a "Client History of Staff Assignments" (AAM section 11,500.05) which lists by client the amount of time expended in prior years. (It should be noted that the form in AAM section 11,500.05 can be adapted to be used for a sole practitioner as well as a large firm.)

.04 Consultation

1. **Areas and specialized situations where consultation is required are identified, and personnel are encouraged to consult with or use authoritative sources on complex or unusual matters.**

   a. A technical reference library is maintained, and I have made arrangements to use the libraries of other practicing CPAs. The AICPA library is also used on a frequent basis.

   b. When presented with a practice question or problem that I may lack the particular expertise to resolve, I refer to the Technical Information Division of the AICPA or the (state) CPA Society established to handle technical inquiries, or I may confer with another CPA who has expertise in the area.

2. **In those areas and specialized situations where firm policy requires consultation with specialists, a summary of the consultation conclusions and the reasons for the conclusions is required.** (See AAM section 11,500.08.)

   Consultation summaries are filed with the engagement working papers. (See AAM section 11,500.07.)

.05 Supervision

1. **All engagements are adequately planned, and procedures are provided for maintaining the firm's standards of quality for the work performed.** (For additional information on Planning, review AAM section 3000.)

   a. On all recurring engagements, I annually review the following documents from the prior year's files, as applicable, to determine if modifications are appropriate:

   (i) Engagement letter

   (ii) Time budget compared with actual time expended

   (iii) Evaluation of the internal control structure

   (iv) Audit or work program

   (v) Engagement notes and memorandums

   (vi) Financial statement and accountant's report

   (vii) Management letters

   (viii) Planning memorandum

   The foregoing items are prepared, where applicable, for new and special engagements, and a memorandum is prepared stating special problems, if any, that may have an impact on the conduct of the engagement.

   b. Copies of forms, checklists, and questionnaires are available for use on engagements.

2. **All engagement working papers and reports are reviewed prior to issuing the report.** (For additional information on Supervision, see AAM section 9000.)

a. I review and initial the work of my part-time employee.

b. I review and initial my own work after waiting at least until the following day.

c. Checklists are utilized for reviewing engagement working papers and reports.

.06 Hiring

1. **The firm endeavors to obtain qualified personnel and has established qualifications and guidelines for evaluating potential hirees.** (See AAM section 11,500.09 for an example of a Pre-Employment Application which can be used to determine the individual's qualifications and AAM section 11,500.10 for an example of an Interview Report which can be used to document the interviewer's comments about individuals interviewed for positions within the firm.)

    a. During my busy season, I normally employ a college senior who has completed substantially all of the accounting curriculum course requirements for graduation.

    b. I interview potential employees and appropriately investigate their backgrounds to reasonably assure my hiring persons with acceptable qualifications.

2. **New personnel are informed of the firm's policies and procedures relevant to them.**

    A copy of this quality control document is presented to newly hired personnel.

.07 Professional Development

1. **I have an annual professional development requirement.**

    a. I am a member of the AICPA and the (state) CPA Society and participate in professional activities.

    b. I complete a minimum of 40 hours of formal continuing professional education each year in areas related to my practice. (Firms should determine the specific requirements of their State Board of Accountancy.) A record of professional development hours is maintained, updated, and periodically reviewed. (See AAM section 11,500.11.) The types of programs qualifying for the fulfillment of the forty-hour requirement include—

    (i) Continuing professional education programs of the AICPA and the (state) CPA Society. These include sessions attended and, with written evidence of completion, cassette/workbook, or workbook programs.

    (ii) College courses related to the profession.

2. **Information about current developments in professional technical standards and materials containing the firm's technical policies and procedures are made available to personnel.**

    I receive and review statements relating to current developments in accounting and auditing including statements and interpretations issued by the Financial Accounting Standards Board, the Governmental Accounting Standards Board, the AICPA Auditing Standards Board, and other AICPA technical committees.

3. **On-the-job training accounts for a significant part of professional development.**

    I provide for on-the-job training by discussing with my part-time employee the relationship of his work to the engagement as a whole. Also, during my review of working papers prepared by my part-time employee, I explain the need for any additional work requirements discovered through the review process.

.08 Advancement

The element of advancement is inapplicable because the firm uses only part-time staff.

.09 Acceptance and Continuance of Clients

1. **Procedures are established for evaluation of prospective clients and for their acceptance as clients.** (See AAM section 11,500.18 for a New Client Acceptance Checklist which can be used for prospective clients.)

   a. I obtain and review available financial information regarding the prospective client (such as annual and interim financial statements and income tax returns).

   b. I make inquiries about potential clients to bankers, attorneys, credit services, and others having business relationships with the company.

   c. I contact predecessor auditors, where applicable, and make inquiries in accordance with generally accepted auditing standards.

   d. I consider circumstances that would cause the firm to regard the engagement as one requiring special attention or presenting unusual risks. These circumstances include the following:

      (i) Audits where the expected man-hour requirement exceeds seventy-five hours

      (ii) Audits of firms operating in high-risk industries, such as those industries where it is difficult to establish an adequate internal control structure or those industries whose operations are especially sensitive to general economic conditions

      (iii) Audits of firms in the development stage

      (iv) Audits of firms in serious financial difficulty

      (v) Audits of firms experiencing change in any of the following: management or ownership, legal counsel, financial condition, litigation status, nature of business, or scope of engagement

   e. I evaluate the firm's independence and ability to adequately serve a potential client. In evaluating the firm's ability, I give consideration to the requirements for technical skills, knowledge of the industry, and personnel.

   f. A review is made to ensure that acceptance of the client would not violate applicable regulatory agency requirements and the code of professional conduct of the AICPA and/or the (state) CPA Society.

   g. I assemble, evaluate, and document the items listed above before making an acceptance decision.

2. **Clients are evaluated at the end of specific periods or upon the occurrence of certain events to determine whether the relationship should be continued.** (See AAM section 11,500.19 for a Client Evaluation Questionnaire, which can be used for evaluating existing clients.)

   a. Reevaluations of existing clients are made—

      (i) Annually, if any of the conditions mentioned in 1(*d*) above exist.

      (ii) Every three years if none of the conditions mentioned in 1(*d*) above exist.

      (iii) Upon the emergence of conditions that would have caused me to reject a client had such conditions existed at the time of the initial acceptance.

   b. I prepare an annual memorandum documenting the evaluations.

.10 Inspection

1. **The firm conducts an inspection program regarding its quality control policies and procedures.** (See AAM section 11,500.20 for a Summary Inspection Report, which can be used to document the results of a firm's yearly quality review inspection, and AAM section 11,500.21 for an Inspection of Compliance With Policies and Procedures Relating to Elements of Quality Control.)

   Each year, I evaluate the firm's quality control policies and procedures for compliance with professional standards by use of AICPA and/or (state) Society checklists. This procedure includes a review of administrative, personnel, and engagement files sufficient to obtain reasonable assurance that quality control policies and procedures are being complied with. An inspection program is not conducted during the year in which the firm has a quality review.

2. **The firm adheres to the quality control standards that have been established by the AICPA.**

   Every three years there is a quality review of the firm's accounting and auditing practice. This review is performed by either a peer firm qualified to perform the review or a team assembled by the AICPA or state society of CPAs.

3. **Provision is made for reporting inspection findings and for monitoring actions taken or planned.**

   I evaluate inspection findings and recommendations together with suggested corrective actions and prepare and retain a memorandum documenting that the inspection has been performed. Appropriate corrective actions, if any, are taken.

.11 Stated Objectives of Firm (Philosophy)

A particular firm's stated objectives may include items such as the following:

1. Concern for the general public interest.
2. Concern for the financial well-being of clients.
3. Reinvestment of the firm's profits in the training and advancement of personnel.
4. Growth plans including opening of branch offices, annual billings, and staff size.
5. Development of specialties such as auditing governmental units or concentration in particular fields—agriculture, retail, and so forth.
6. Development of other services such as a computer data processing center.
7. Pattern for firm growth—internal growth through acquisitions of clients and growing apace with them or growth through mergers with other accounting firms.

[The next page is 11,401.]

AAM Section 11,400

Sample Quality Control Document for a Sole Practitioner CPA Firm With Full-Time Staff

.01 Firm Background Information

The firm was founded in 19XX after the proprietor gained several years' experience with a local CPA firm. Presently, our full-time staff consists of two professional employees and a secretary. One per diem accountant is hired during the busy season. An accounting student and a secretary are available on a part-time basis, as needed.

The firm's objectives are to—

- Provide high-quality accounting, auditing, tax, and management advisory services to growth-oriented companies in our geographic area.
- Serve clients with outstanding business potential and to help each company reach its maximum potential through sound and efficient accounting, financial, and management advice.
- Be actively involved in professional, business, community, and civic affairs.
- Offer close, personalized service on a timely basis.

In order to achieve these goals and objectives, the firm seeks to grow through a combination of expanded service to present clients and the addition of new clients on a regular basis.[1]

Our practice is conducted from one office, and our clientele, consists of retail establishments, manufacturing companies, service companies, and nonprofit organizations.

May 31, 19XX

.02 Independence

1. **All personnel are required to adhere to the independence rules, regulations, interpretations, and rulings of the AICPA, (state) CPA Society, (state) Board of Accountancy, and state statutes.**

    a. Mr. (practitioner) is responsible for resolving questions relating to independence matters and is available to provide guidance when required.

    b. Mr. (practitioner) communicates with the AICPA and/or the (state) CPA Society for assistance in resolving independence questions that are not satisfactorily resolved within the firm. (See AAM section 11,500.07 for an example of a log, which can be utilized to document all communication with parties outside the firm. Also see AAM section 11,500.08 for a Consultation Worksheet, which can be used to document the subject matter, as well as the response from the consultant.)

    c. A memorandum documenting the resolution of independence questions is prepared and retained by Mr. (practitioner); the other firm personnel review and initial the memorandum if the question relates to their independence.

2. **Policies and procedures relating to independence are communicated to all personnel.**

[1] Additional considerations for establishing a firm's stated objectives are discussed in AAM section 11,400.11.

a. Memorandums are used to inform personnel of the firm's independence policies and procedures and advise them that they are expected to be familiar with those policies and procedures. Rulings and interpretations of the AICPA, (state) CPA Society, (state) Board of Accountancy, and state statutes are also made available to personnel.

b. An independent mental attitude is emphasized during the conduct of engagements.

c. I review the current client listing with each new employee to ensure that the employee is aware of those entities to which independence policies apply. During the monthly staff meeting, the staff is informed of any changes in the listing.

d. Our library contains professional, regulatory, and firm literature relating to independence matters.[2]

3. **Compliance with policies and procedures relating to independence is monitored.**

a. Annually, all staff members are required to complete a questionnaire (see AAM section 11,500.01), indicating that—

(i) They are familiar with the firm's independence policies and procedures.

(ii) They are not now nor have been holding prohibited investments

(iii) They are not now nor have been involved in relationships or transactions that are prohibited.

b. Mr. (practitioner) is responsible for the resolution of exceptions to the firm's policies and procedures relating to independence.

c. Accounts receivable that are past due are reviewed monthly by Mr. (practitioner) to ascertain whether any outstanding amounts take on some of the characteristics of loans and may, therefore, impair the firm's independence.

.03 Assigning Personnel to Engagements

1. **Our firm's approach to assigning personnel includes the planning of overall firm needs and the measures employed to achieve a balance of engagement manpower requirements, personnel skills, individual development, and utilization.**

a. On an annual basis, normally in September of each year, Mr. (practitioner) develops a projection containing anticipated manpower requirements for the next year. (See AAM section 11,500.06.)

b. In scheduling assignments, Mr. (practitioner) strives to achieve a balance of engagement manpower requirements, personnel skills, individual development, and utilization, taking into consideration—

(i) Engagement size and complexity

(ii) Personnel availability

(iii) Special expertise required

(iv) Timing of the work to be performed

2. **Mr. (practitioner) is responsible for assigning personnel to engagements.** (See AAM section 11,500.04—.05 for examples of forms which can be used to facilitate assigning personnel to specific engagements.)

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[2] The appropriate information may be found in *AICPA Professional Standards*, volume 2, and in rulings and interpretations of the state CPA societies, the state boards of accountancy, and state statutes.

a. Before the assignment of a professional employee to an engagement, Mr. (practitioner) considers the nature of the engagement, personnel availability, extent of supervision required, and possible independence problems or conflicts of interest.

b. To the extent practicable, Mr. (practitioner) attempts to achieve a balance between the need for continuity and for periodic rotation of staff.

.04 Consultation

1. **Areas and specialized situations where consultation is required are identified, and personnel are encouraged to consult with or use authoritative sources on complex or unusual matters.**

a. All personnel are advised of our firm's consultation policies and procedures. These policies and procedures are set forth in a memorandum.

b. Certain areas or specialized situations have been identified as requiring consultation because of their nature or complexity. They include the following:

(i) Application of newly issued technical pronouncements.

(ii) Industries with special accounting, auditing, or reporting requirements.

(iii) Emerging practice problems.

(iv) Choices among alternative generally accepted accounting principles when an accounting change is to be made.

c. A technical reference library is maintained, and arrangements have been made to use the libraries of other practicing CPAs. The resources of the AICPA library are drawn upon when needed.

d. When expertise is not available within the firm, practice questions and problems are referred by Mr. (practitioner) to the Technical Information Division of the AICPA or the (state) CPA Society established to handle technical inquiries.

e. We maintain a consultation agreement with the local office of (firm name) CPAs, to provide us with additional expertise. Inquiries to that firm are channeled through Mr. (practitioner).

2. **In those areas and specialized situations where firm policy requires consultation with specialists, a summary of the consultation conclusions and the reasons for the conclusions are required.**

a. The consultation policy memorandum is used to inform personnel of the consultation procedures, the extent of documentation required, and the responsibility for its preparation.

b. Consultation worksheets (see AAM section 11,500.08) are filed with the engagement working papers.

.05 Supervision

1. **All engagements are adequately planned.** (For additional information on Planning, review AAM section 3000.)

a. On all annual recurring engagements, the staff accountant reviews with Mr. (practitioner) (or Mr. (practitioner) reviews alone) the following documents from the prior year's files, as applicable, to determine if modifications are appropriate:

(i) Engagement letter

(ii) Time budget compared with actual time expended

(iii) Evaluation of the internal control structure

(iv) Audit or work program

(v) Engagement notes and memorandums

(vi) Financial statements and accountant's report

(vii) Management letters

(viii) Planning memorandum

b. For all engagements (including annual recurring engagements, new engagements, and special engagements), the staff accountant submits to Mr. (practitioner) the following, where applicable, for his written approval, or Mr. (practitioner) prepares, where applicable, the following:

(i) Engagement letter

(ii) Time budget

(iii) Preliminary evaluation of the internal control structure

(iv) Audit or work program

(v) A memorandum stating the special problems, if any, that may have an impact on the conduct of the engagement

(vi) Planning memorandum

2. **Procedures are provided for maintaining the firm's standards of quality for the work performed.**

   a. Depending upon each individual's background in relation to his assignment, varying degrees of supervision are provided.

   b. Copies of forms, checklists, and questionnaires are available for use on engagements.

   c. Differences of opinion among staff members working on an engagement are resolved by Mr. (practitioner). Any party to the discussion who disagrees with the conclusion has the option of preparing a memorandum and filing it with the working papers.

3. **All engagement working papers and reports are reviewed prior to issuance of the report.** (For additional information on Supervision, review AAM section 9000.)

   a. The staff accountant reviews and initials all working papers he did not prepare (excluding those prepared by Mr. (practitioner)).

   b. Mr. (practitioner) reviews the overall engagement (including his own working papers after waiting at least one day following their preparation) by completing a review checklist.

.06 Hiring

1. **The firm endeavors to obtain qualified personnel by planning for personnel needs and establishing hiring objectives.**

   a. Mr. (practitioner) annually plans the firm's long-range personnel objectives. Current clientele, anticipated growth, personnel turnover, individual advancement, and retirement are among the criteria considered.

   b. Mr. (practitioner) makes the employment decisions.

2. **Our firm has established qualifications and guidelines for evaluating potential hirees.** (See AAM section 11,600.09 for an example of a Pre-Employment Application which can be used to determine the individual's qualifications and AAM section 11,500.10 for an example of an Interview Report which can be used to document the interviewer's comments about individuals interviewed for positions within the firm.)

   a. Our firm seeks to employ individuals with high levels of intelligence, integrity, honesty, motivation, and aptitude for the profession.

   b. Our firm normally employs college and business college graduates with a concentration in accounting as full-time permanent members of its professional and paraprofessional staff. The following general criteria are considered in hiring decisions:

      (i) Academic background

      (ii) Personal achievements

      (iii) Work experience

      (iv) Personal interests

   c. Our firm normally expects that a professional staff applicant have the academic background that will enable him to meet the academic requirements to sit for the CPA examination as administered by the (state) Board of Accountancy.

   d. The backgrounds of potential employees are appropriately investigated to reasonably assure our hiring persons with acceptable qualifications by obtaining completed application forms, college transcripts, personal references, and employment references.

   e. Potential employees are interviewed by Mr. (practitioner) who informs them about the firm.

3. **New personnel are informed of the firm's policies and procedures relevant to them.**

   a. Mr. (practitioner) discusses the firm's personnel policies and procedures with new employees.

   b. A copy of this quality control document is presented to newly hired personnel.

.07 Professional Development

1. **Guidelines and requirements have been established for the firm's professional development program and are communicated to all personnel.**

   a. Mr. (practitioner) and any eligible staff are members of the AICPA and the (state) CPA Society; they also participate in professional activities.

   b. Mr. (practitioner) is responsible for the formulation and implementation of guidelines and requirements for professional development.

   c. As part of their orientation, new employees are informed of professional responsibilities and opportunities by Mr. (practitioner).

   d. Mr. (practitioner) and the full-time professional employees are required to complete a minimum of 40 hours of formal continuing professional education each year. (Firms should determine the specific requirements of their State Board of Accountancy.) Personnel complete the record-of-professional-development form (see AAM section 11,500.11) and forward it to Mr. (practitioner). He reviews the form and has it filed in the individual's personnel file. The types of programs qualifying for the fulfillment of the 40-hour requirement include—

(i) Continuing professional education programs of the AICPA and the (state) CPA Society. This includes sessions attended and, with written evidence of completion, cassette/workbook or workbook programs.

(ii) College courses related to the profession.

e. Mr. (practitioner) annually reviews and approves the firm's professional development program (including personnel participation records) to determine whether it is adequately meeting the firm's needs, providing for the professional growth of individuals, and meeting mandatory continuing education requirements. (See AAM section 11,500.12—.13.)

2. **Information about current developments in professional technical standards and materials containing the firm's technical policies and procedures are made available to personnel. Personnel are encouraged to engage in self-development activities.**

It is the responsibility of Mr. (practitioner) to distribute statements relating to current developments in accounting and auditing to all personnel not receiving them directly. This includes statements and interpretations issued by the Financial Accounting Standards Board, the Governmental Accounting Standards Board, the AICPA Auditing Standards Board, and other AICPA technical committees.

3. **The firm recognizes that on-the-job training accounts for a significant part of professional development.**

a. Mr. (practitioner) provides for on-the-job training by discussing with the engagement staff the relationship of the work they are performing to the engagement as a whole. Also, during the review of working papers prepared by staff members, the proprietor explains the need for any additional work requirements discovered through the review process.

b. When practicable, professional employees are assigned to varying engagement areas.

c. Assignments are monitored to determine that personnel are fulfilling, where applicable, the experience requirements of the (state) Board of Accountancy.

.08 Advancement

1. **The performance of our personnel is continuously evaluated, and personnel are periodically advised of their progress. Personnel files are maintained containing documentation of the evaluation process.**

a. At least annually, all professional employees receive an evaluation of their performance. (See AAM section 11,500.14—.15 for examples of Evaluation Forms which may be used for periodic evaluation of staff members. The differences in the forms relate to the amount of time spent on a particular engagement. For example, if a staff member spends 40 or more hours on an engagement a more thorough evaluation can usually be performed (AAM section 11,500.14). AAM section 11,500.16 would be utilized to evaluate the management skills of the individual being evaluated and therefore does not include specific duties relating to the assignment of work performed.) Such counseling interviews are conducted by Mr. (practitioner). These evaluations summarize performance on engagements during the year. The individual's progress, strengths, weaknesses, future objectives, and the firm's future objectives are among the items discussed.

b. Results of evaluations are documented in the individual's personnel file.

2. **Mr. (practitioner) makes advancement and termination decisions and documents the results.**

.09 Acceptance and Continuance of Clients

1. **Our firm has established procedures for evaluation of prospective clients and for their acceptance as clients.** (See AAM section 11,500.18 for a New Client Acceptance Checklist which can be used for prospective clients.)

   a. Available financial information regarding the prospective client (such as annual and interim financial statements and income tax returns) is obtained and reviewed.

   b. Inquiries about potential clients are made to bankers, attorneys, credit services, and others having business relationships with the company.

   c. Where applicable, predecessor auditors are contacted, and inquiries are made in accordance with generally accepted auditing standards.

   d. Consideration is given to circumstances that would cause the firm to regard the engagement as one requiring special attention or presenting unusual risks. These circumstances include the following:

      (i) Audits where the expected man-hour requirement exceeds ninety hours

      (ii) Audits of firms operating in high-risk industries, such as those industries where it is difficult to establish an adequate internal control structure or those industries whose operations are especially sensitive to general economic conditions

      (iii) Audits of firms in the development stage

      (iv) Audits of firms in serious financial difficulty

      (v) Audits of firms experiencing change in any of the following: management or ownership, legal counsel, financial condition, litigation status, nature of business, or scope of engagement

   e. The firm's independence and ability to adequately serve a potential client are evaluated prior to its acceptance. In evaluating the firm's ability, consideration is given to the requirements for technical skills, knowledge of the industry, and personnel.

   f. A review is made to ensure that acceptance of the client would not violate applicable regulatory agency requirements and the codes of professional conduct of the AICPA and/or the (state) CPA Society.

   g. Mr. (practitioner) assembles, evaluates, and documents the applicable foregoing considerations before making an acceptance decision.

2. **Clients are evaluated at the end of specific periods or upon the occurrence of certain events to determine whether the relationship should be continued.** (See AAM section 11,500.19 for a Client Evaluation Questionnaire which can be used for evaluating existing clients.)

   a. Reevaluations of existing clients are made—

      (i) Annually, if any of the conditions mentioned in 1(*d*) above exist.

      (ii) Every three years if none of the conditions mentioned in 1(*d*) above exist.

      (iii) Upon the emergence of conditions that would have caused the firm to reject a client had such conditions existed at the time of the initial acceptance.

   b. Based on the information obtained, Mr. (practitioner) makes the continuance decision and documents it with a memorandum.

.10 Inspection

1. **The firm conducts an inspection program regarding its quality control policies and procedures.** (See AAM section 11,500.20 for a Summary Inspection Report, which can be used to document the results of a firm's yearly quality review inspection, and AAM section 11,500.21 for an Inspection of Compliance With Policies and Procedures Relating to Elements of Quality Control.)

   Using AICPA and/or (state) Society checklists, Mr. (practitioner) annually evaluates the firm's quality control policies and procedures for compliance with professional standards. This procedure includes a review of administrative, personnel, and engagement files sufficient to obtain reasonable assurance that quality control policies and procedures are being complied with. An inspection program is not conducted during the year in which the firm has a quality review.

2. **The firm adheres to the quality control standards that have been established by the AICPA.**

   Every three years there is a quality review of the firm's accounting and auditing practice. This review is performed by either a peer firm qualified to perform the review or a team assembled for the review purpose.

3. **Provision is made for reporting inspection findings and for monitoring actions taken or planned.**

   Mr. (practitioner) evaluates the inspection findings and recommendations together with suggested corrective actions and prepares and retains a memorandum documenting that the inspection has been performed. Appropriate corrective actions, if any, are taken.

.11 Stated Objectives of Firm (Philosophy)

A particular firm's stated objectives may include items such as the following:

1. Concern for the general public interest.
2. Concern for the financial well-being of clients.
3. Reinvestment of the firm's profits in the training and advancement of personnel.
4. Growth plans including opening of branch offices, annual billings, and staff size.
5. Development of specialties such as auditing governmental units or concentration in particular fields—agriculture, retail, and so forth.
6. Development of other services such as a computer data processing center.
7. Pattern for firm growth—internal growth through acquisitions of clients and growing apace with them or growth through mergers with other accounting firms.

[The next page is 11,501.]

AAM Section 11,500
Sample Quality Control Forms

.01 Independence Checklist for Employees

Office ______________________________

Employee name ______________________________

In order to determine that the firm and its employees are in compliance with the independence rules, regulations, interpretations and rulings of the AICPA, the (name of State) CPA Society, the (name of State) Board of Accountancy, and state statutes the following must be completed by ________ (date) and returned to ________ as noted at the end of the form. If there are any questions you have related to the completion of the form, or if there is a matter that has come to your attention which may impair the firm's independence, please contact (name of Partner) to resolve the problem.

		Yes	No
1.	Do you have a direct or indirect material financial interest in a client* or its subsidiaries and affiliates?	___	___
2.	Do you have a financial interest in any major competitors, investees, or affiliates of a client*?	___	___
3.	Do you have any outside business relationship with a client* or an officer, director, or principal stockholder having the objective of financial gain?	___	___
4.	Do you owe any client* an amount, except a normal consumer note payable or home mortgage made by a financial institution under normal lending procedures, terms, and requirements?	___	___
5.	Do you have a note or account receivable from a client*, except for a deposit in a financial institution?	___	___
6.	Do you have the authority to sign checks for a client*?	___	___
7.	Are you connected with a client* as a promoter, underwriter or voting trustee, director, officer or in any capacity equivalent to a member of management or an employee?	___	___
8.	Do you serve as a director, trustee, officer, or employee of a nonprofit organization that is a present client*?	___	___
9.	Has your spouse or minor child been employed by a client*?	___	___
10.	Has anyone in your legal family, or any blood relative, been employed in any type of managerial position by a client*?	___	___
11.	Are any billings delinquent for clients* that are your responsibility?	___	___

I have read the Firm's Independence Policy and AICPA standards. I believe I understand the independence policy and standards. I am in compliance except for the exceptions listed below. (Exceptions to policies: A "Yes" answer to the independence checklist is an exception. Give details as to names, addresses, amounts (relationships of amounts to your net worth is relevant), etc. Leaving the space blank indicates you have no exceptions.)

* Client. The enterprise with whose financial statements the member is associated.

Arrangements made to dispose of above exceptions to comply with policies:

Signature	Date Reviewer's initials
Exceptions approved by	Location

Instructions: Sign and return to ______ within one week after starting work. Annually, a new form must be completed during the first week of September.

.02 Independence and Representation Checklist for Other Auditors

Office ______________________

Firm name ______________________

In order to determine that your firm is in compliance with the independence standards, regulations, interpretations and rulings of the AICPA, the (name of State) CPA Society, the (name of State) Board of Accountancy, and (name of State) statutes the following must be completed by ________ (date) and returned to ______ as noted. If there are any questions you have related to the completion of the form, or if there is a matter that has come to your attention which may impair your firm's independence, please contact (name of Partner) to resolve the problem.

		Yes	No
1.	We are aware that [Name of primary auditor] has been engaged to audit the financial statements of [Name of parent] as of [Date] and for the [period, e.g., year] then ended.	___	___
2.	We are aware that [Name of primary auditor] plans to rely on our audit of the financial statements of [Name of subsidiary or component] as of [Date] and for the [period, e.g. year] then ended.	___	___
3.	[We are aware that the primary auditor will refer to our report in their report.]	___	___
4.	We are independent with respect to [Name of both the parent and subsidiary or component].	___	___

______________________ ______________________

Partner of other audit firm Date

Reviewed by:

____

Partner of primary audit firm

.03 Scheduling Request

Client ______________________ Engagement No. __________ Year End __________

Partner ______________________ Manager __________ Tax Ptr/Mgr __________

Personnel Requested	Experience Level	Interim From	Interim Thru	Interim Hours	Year End From	Year End Thru	Year End Hours	Total Hours

Audited? Yes____ No____
SEC? Yes____ No____
Reviewed? Yes____ No____
Compiled? Yes____ No____

Industry ______________________

Estimated total hours:
Partner ______________________
Manager ______________________
Staff ______________________
Total

Can dates be adjusted? Yes____ No____ Explain ______________________

Can personnel be changed? Yes____ No____ Explain ______________________

Comments ______________________

____

____

Requested by ______________________ Date __________ Scheduled ______________ Date __________
Assignment Manager

.04 History of Staff Assignments

NAME ______________________________

				ASSIGNMENT DESCRIPTION				
	DATES							
CLIENT/ LOCATION	INTERIM	YEAR END	RESPONSIBILITY LEVEL	TOTAL HOURS	INDUSTRY	SEC	AUDIT AREAS PERFORMED	REPORTED TO

.05 Client History of Personnel Assigned

CLIENT ______________________________ LOCATION ______________

YEAR ENDING ____________ AUDITED? YES _____ NO ____ SEC? YES ________ NO ________

FISCAL	HOURS		ENTER NAMES AND CHARGEABLE HOURS FOR THE YEAR							
YEAR	INTERIM	YEAR END	PARTNER	MANAGER	SENIOR	IN-CHARGE	STAFF	STAFF	STAFF	STAFF

.06 Scheduling Master Plan

MONTH OF ______

			Nonworking hours							Nonrecurring assignments				Hours for month		
												Other				
Staff member	Carry forward	Month assignments	Vacation	Holiday	Prof dev.	Comp time	CPA exam	Admin	Other	Tax dept	Review dept	client #	hr	Total assign	Available	(Over) under
Aston	XX	XX	XX	X	X		X					XXXXXX	X	XXX	X	XX
Barry	XX	X	XX	X	X			X	X					XXX	XX	X
Casey	X	X	X	X					X	X				XXX	XX	XX
Davis	XX	X	X	X	X	X	X	X	X	X	X	XXXXXXX	XX	XXXX	XX	(XX)
Evans	X	X	X	X	X	X						XXXXXXX	XX	XXXX		(XX)
Frank	XX	X	X	X	X	X	X	X	X	X	X	XXXXXXX	XX	XXXX	X	(XX)
Louis	XX	X	XX	X	X	X		X		X				XXX	XX	XX
Miceli	XX	X	XX	XX	X	X	X	X						XXX	XX	XX
Total	XXXX	XX	XXX	XXX	XX	XX	XX	XX	XX	XX	XX		XXX	XXX	XXX	XXX

.07 Consultation Log

DATE	MODE OF COMMUNICATION	CLIENT	OFFICE	REQUEST	RESPONSE	MEMORANDUM REQUIRED YES/NO	MEMORANDUM DATE REC'D

.08 Consultation Worksheet

DATE______________________________

CLIENT NAME________________________

LOCATION__________________________

ENGAGEMENT (TYPE)__________________

SUBJECT (QUESTION)____

CONSULTANT'S RESPONSE: (Cite Professional literature discussed and conclusion of consultant)__________

FINAL RESOLUTION____

________________________ ________________________
Senior/Manager Date

________________________ ________________________
Partner Date

.09 PRE-EMPLOYMENT APPLICATION

NAME	DATE

ADDRESS

TELEPHONE NUMBER	SOCIAL SECURITY NUMBER

POSITION APPLIED FOR

FIRST CHOICE	SECOND CHOICE	MINIMUM SALARY REQUIRED: $

☐ Full Time ☐ Permanent Part Time ☐ Temporary ☐ Summer Temporary

REFERRED BY
☐ Newspaper ad ________ NAME ☐ Agency ________ NAME ☐ Friend ________ NAME ☐ Other ________ NAME

EDUCATIONAL BACKGROUND— ☐ See Below ☐ See Attached Resume

	NAME & LOCATION OF SCHOOL	MAJOR COURSE	YEARS ATTENDED		YEAR GRAD.
			FROM	TO	
Elementary					
High or Vocational					
Business or Technical					
College					
Graduate					

ADDITIONAL SKILLS OR MACHINE KNOWLEDGE ☐ See Below ☐ See Attached Resume

NOTE: See exhibit 304-2 of the AICPA MAP Handbook for an alternative.

EMPLOYMENT HISTORY— ☐ See Below ☐ See Attached Resume List present (or if currently unemployed, most recent) position first.

FROM	TO	EMPLOYER'S NAME	EMPLOYER'S ADDRESS	POSITION OR TITLE	SUPERVISOR	REASON FOR LEAVING

USE THIS SPACE TO ACCOUNT FOR PERIODS NOT WORKED	ADDITIONAL INFORMATION HELPFUL IN CONSIDERING EMPLOYMENT

AGREEMENT

"I certify that the information given by me in this application is true in all respects, and I agree that if employed and it is found to be false in any way, that I may be subject to dismissal without notice, if and when discovered. I authorize the use of any information in this application to enable to verify my statements, and I authorize , past employers, doctors, all references and any other persons to answer all questions asked by concerning my ability, character, reputation, and previous employment record. I release all such persons from any liability or damages on account of having furnished such information. I further agree, if employed, that (i) I am to work faithfully and diligently, to be careful and avoid accident, to come to work promptly, and I am not to be absent for any reason without prior notice to my supervisor, (ii) upon termination of employment, may answer all questions asked of any prospective employer concerning my ability, character, reputation and employment record. I agree to submit to a physical examination whenever requested by and, if employed, I agree to abide by all present and subsequently issued personnel policies and rules of

APPLICANT'S SIGNATURE: ______________________ DATE ______________

.10 INTERVIEW REPORT

DAY ____________________

DATE ____________________

TIME ____________________

NAME OF APPLICANT ____

POSITION APPLIED FOR ____

COMMENTS BY INTERVIEWER:

RECOMMENDED ACTION:

INTERVIEWED BY: ________________________ TITLE: ________________________

PLEASE RETURN TO HUMAN RESOURCES AS SOON AS POSSIBLE

NOTE: See exhibit 303-6 of the AICPA MAP Handbook for an alternative.

.11 Record of Professional Development

Name ____________________ **Employee No.** ____________

Out-of-Office Courses:

	Sponsor	Course description	No. of hours	Date completed
1.				
2.				
3.				
4.				
5.				
6.				
7.				
8.				
9.				
10.				

In-House Programs:

	Instructor	Course description	No. of hours	Date completed
1.				
2.				
3.				
4.				
5.				
6.				
7.				
8.				
9.				
10.				

.12 19XX Professional Development

Summary *(in hours)*

	In-house presentations			
	Developed in-house	Purchased programs	Outside courses	Total
Partners/Owners				
1.				
2.				
3.				

	In-house presentations			
	Developed in-house	Purchased programs	Outside courses	Total
Professional staff				
1.				
2.				
3.				
4.				
5.				
6.				
7.				
8.				
Paraprofessionals				
1.				
2.				
3.				
4.				

.13 19XX Professional Development

Summary *(in dollars)*

	Purchased programs for in-house use	Outside courses	Total
Partners/Owners			
1.	$	$	$
2.			
3.			
Professional staff			
1.			
2.			
3.			
4.			
5.			
6.			
7.			
8.			
Paraprofessionals			
1.			
2.			
3.			
4.			

.14 Performance Evaluation

[To be completed after each engagement of forty hours or more.]

Name ______________________________ Classification ______________

Client ______________________________ From __________ To __________

Describe work assigned: ______________________________

____

____

In your opinion based on the staff member's classification, should this assignment be considered:

Demanding ☐ Routine ☐

This individual is ☐ is not ☐ ready for increased responsibility. Explain ______________

____

Rating: Enter comments which describe the staff member's performance on this engagement. Rate the staff member on each of the items below as Outstanding (O), Very High (VH), Good (G), Below Normal (BN), or Not Applicable (NA).

[Support each caption with specific incidents or remarks.]

Technical Knowledge: Did the staff member possess adequate technical knowledge to function effectively at the level assigned? Did this knowledge encompass accounting principles, auditing standards, and tax accounting? Has the staff member kept current on recent developments and new pronouncements on professional practice matters as they affected this engagement?

	O	VH	G	BN	NA
Rating:	☐	☐	☐	☐	☐

____

____

____

Analytical Ability and Judgment: How well did the staff member recognize problems, develop relevant facts, formulate alternative solutions, and decide on appropriate conclusions? Did the staff member distinguish between material and immaterial items? Was the staff member practical in adapting theory and experience to the individual circumstances of this client?

	O	VH	G	BN	NA
Rating:	☐	☐	☐	☐	☐

____

____

____

Written and Oral Expression: Evaluate the effectiveness of the staff member's letters, memoranda, and other forms of written communication. In conversation, did the staff member communicate intentions effectively? Were instructions understood the first time? Did the staff member sell ideas, obtain acceptance and action?

	O	VH	G	BN	NA
Rating:	☐	☐	☐	☐	☐

____

____

____

NOTE: See exhibit 307-7 of the AICPA MAP Handbook for an alternative.

Performance: Can you depend on the staff member for sustained, productive work? Were assignments organized and completed accurately in a reasonable amount of time? Did the staff member readily assume responsibility? Did the staff member meet time estimates and document work papers properly?

	O	VH	G	BN	NA
Rating:	☐	☐	☐	☐	☐

Development of Personnel: In assigning work, did the in-charge staff member make the most effective use of available talent in terms of getting the work done and in terms of developing staff members performing the work? Did the in-charge staff member tend to make assignments which were either too easy or too hard for his subordinates? Was the staff member readily accepted as a leader? Was the staff member effective in on-the-job coaching?

	O	VH	G	BN	NA
Rating:	☐	☐	☐	☐	☐

Client Relations: How well did the staff member relate to this client and gain his acceptance? How well did the staff member recognize and take advantage of practice development opportunities, through extension of services to this client?

	O	VH	G	BN	NA
Rating:	☐	☐	☐	☐	☐

Attitude: Did the staff member demonstrate a positive and professional approach to the assignment? Was this demonstrated by sustained effort in completing work? Was the assignment undertaken with enthusiasm and zest? Did the staff member respond in a positive way to suggestions and guidance from superiors? To what degree did the staff member make personal sacrifices to meet client requirements? Was the staff member a helpful member of the team? Did the staff member go out of his way to help an associate?

	O	VH	G	BN	NA
Rating:	☐	☐	☐	☐	☐

Personal Characteristics: Did the staff member possess self-confidence and was this confidence projected in an acceptable way? Were positive impressions created with this client and with associates? Did the staff member have a keen sense of what to do or say (tact)? Were clothes appropriate to professional work? Was the staff member well groomed?

	O	VH	G	BN	NA
Rating:	☐	☐	☐	☐	☐

Strong points which were evident: ____________________

Recommendations for improvement: ____________________

Comments of Staff Member Being Evaluated: ____________________

Signatures:

Evaluated staff member ____________________ Date __________

Evaluator ____________________ Title __________ Date __________

Engagement manager ____________________ Date __________

Partner ____________________ Date __________

.15

JOB EVALUATION REPORT
[For Assignments of Thirty (30) Hours or More]

Name ______________________________

Location ______________________________

Engagement ______________________________

Assistant ______________ **In-Charge** ______________

	Compared to Others in Peer Group							
	A	A-	B+	B	B-	C+	C	
	SUPERIOR	EXCELLENT	ABOVE AVERAGE	SATISFACTORY	IMPROVEMENT DESIRED	IMPROVEMENT REQUIRED	UNSATISFACTORY	NOT APPLICABLE
A. PERFORMANCE ON THE JOB								
1. *Technical Ability Demonstrated*								
a) The purpose of the audit procedures planned was understood								
b) Materiality was neither underestimated nor overestimated								
c) Accounting theory and current releases of the profession were applied correctly								
d) Federal and state income tax regulations were applied correctly								
2. *Working Paper Evidence*								
a) Documentation of work performance, including adequate indexing and cross referencing								
b) Sound explanations and conclusions								
c) Use of standard work papers								
d) Legibility								
e) Accuracy — absence of mathematical errors								
3. *Completing This Job*								
a) Meeting planned time estimates								
b) Completing reports and tax returns								
c) Following up the reviewer's comments and making the necessary changes								
4. *Client Reaction on This Job*								
a) Getting along with the client's employees								
b) Interest in the client's business								
B. ENGAGEMENT ADMINISTRATION — (For In-Charge Accountants Only)								
1. *Effectiveness of Proper Planning*								
a) Extent that the scope of the work related to internal control								
b) Developing the work program								
2. *Utilizing Staff Effectively and Efficiently*								
a) Advance planning to minimize crises								
b) Efficient use of staff on the job								
c) On-the-job training of assistants								
3. *Meeting Deadlines*								
a) Completing the engagement in the planned time								
b) Delivering completed pencil copies of the report and tax returns to the supervisor as agreed								
4. *The Product*								
a) Quality of report preparation, including adequate and informative disclosures								
b) Quality of the management advice recommendations								
5. *Practice Management*								
a) Extending services								
b) Ease of collecting for services performed								

.16

Knowledge and Skill Form

(and Profile of Management Role Performance)

Staff member evaluated ____________________ Date ____________________

Evaluator ____________________

Indicate most effective and least effective roles by placing a check in the far left or right hand column (maximum of two each). For the other five traits, indicate relative strength of staff member by placing a check in columns 2, 3, or 4.

(Circle at least two but not more than four in each section and indicate the effectiveness of each trait.)

			If you wish, add your own words.	Effectiveness: Least 1	2	3	4	Most 5
Planner Careful Imaginative Routine Constant	Sloppy Foresighted Erratic Cautious	Thorough Infrequent Last-minute Meticulous						
Problem solver Analytical Critical Hasty Slow	Consistent Faulty Creative Quick	Superficial Routine Reliable Successful						
Communicator Warm Inhibited Thorough Expressive	Sloppy Weak Receptive Efficient	Cold Unstructured Patient Precise						
Leader Dominating Uncertain Weak Loose	Excitable Permissive Fair Amiable	Partial Energetic Heavy-handed Sure						
Decision maker Decisive Slow Quick Frequent	Lone Avoider Seldom Rash	Delayer Reliable Participative Dependent						
Trainer Systematic Patient Sloppy Off-on	Unprepared Efficient Diligent Slow	Conscientious Knowledgeable Disinterested Enthusiastic						
Team member Cooperative Influential Conformist Forceful	Unreliable Divisive Reliable Reluctant	Independent Undisciplined Contributing Welcome						
Innovator Original Infrequent Unnecessary Constant	Appropriate Clever Creative Disruptive	Consistent Sensible Unimaginative Rash						
Job expertise Amateur Obsolete Masterful Versatile	Improving Mediocre Balanced Up-to-date	Too technical Disinterested Lagging Thorough						

(Complete Annually)

Time Period Involved		.17 EMPLOYEE ANNUAL PERFORMANCE APPRAISAL	▱ EXEMPT ▱ NON-EXEMPT
From	To		

Name	Position Title	Number

Hire Date	Present Position Date	Days Absent From:______ To:______ Charged To Sick Time:______ Disability:______

Strengths	Development Needs
	Suggested Plan for Performance Improvement

Summary

Overall Rating on Having Met Job Requirements	
Non-Exempt - Circle One	Exempt - Circle One
1 2 3	1 2 3 4 5
1 = Did Not Meet Job Requirements	1= Did Not Meet Job Requirements 2= Met Most
2 = Met All 3 = Exceeded	3 = Met All 4 = Exceeded 5 = Far Exceeded

Review the following questions before answering them, using the following criteria:

- A "yes" answer should be considered for possible mention as a "strength". If so, refer to it on the first page of this evaluation.

- A "no" answer should be considered for possible mention as a "development need". If so, refer to it on the first page of this evaluation.

All answers should be considered in arriving at an overall rating on having met job requirements.

	CHECK AS APPROPRIATE				
	Strength	Yes	N/A	No	Development Need
Quality of Work					
Is work accurate, neat and clearly presented?	( )	( )	( )	( )	( )
Carefully planned, well organized and thorough?	( )	( )	( )	( )	( )
Productivity					
Is a good level of production maintained?	( )	( )	( )	( )	( )
Are deadlines met?	( )	( )	( )	( )	( )
Are pressure situations handled effectively?	( )	( )	( )	( )	( )
Knowledge of Job					
Does the individual know where to get information?	( )	( )	( )	( )	( )
Is the individual used as a source of information by others?	( )	( )	( )	( )	( )
Communication					
Does the individual ask for clarification when necessary?	( )	( )	( )	( )	( )
Does the individual respond to others in a manner that indicates understanding?	( )	( )	( )	( )	( )
Are ideas expressed so that others are able to understand them?	( )	( )	( )	( )	( )
Human Relations					
Does the individual cooperate with others to get the job done?	( )	( )	( )	( )	( )
Does the individual demonstrate tact and courtesy in dealing with others?	( )	( )	( )	( )	( )
Does the individual maintain a good working relationship with all others?	( )	( )	( )	( )	( )
Are questions and requests dealt with in a helpful manner?	( )	( )	( )	( )	( )
Need for Supervision					
Can the individual be relied upon to get work done without close supervision?	( )	( )	( )	( )	( )
Does the individual take the initiative when appropriate?	( )	( )	( )	( )	( )

	CHECK AS APPROPRIATE				
	Strength	Yes	N/A	No	Development Need
Problem Solving					
Does the individual collect the data needed to solve problems?	( )	( )	( )	( )	( )
Are problems solved quickly?	( )	( )	( )	( )	( )
Are solutions reasonable and accurate?	( )	( )	( )	( )	( )
Does the individual know when to ask for advice and whom to ask?	( )	( )	( )	( )	( )
Does the individual seek out methods to do work more efficiently?	( )	( )	( )	( )	( )
Are alternate solutions generated when appropriate?	( )	( )	( )	( )	( )
Work Habits					
Does the individual comply with the Institute's established work hours?	( )	( )	( )	( )	( )
Does the individual provide proper notification when absent from work?	( )	( )	( )	( )	( )
Personal Development					
Does the individual try to expand on required knowledge and skills?	( )	( )	( )	( )	( )
Does the individual readily grasp and master the new job requirements?	( )	( )	( )	( )	( )
Does the individual show ambition by building on strengths and working on deficiencies?	( )	( )	( )	( )	( )
Is the individual a good candidate for promotion?	( )	( )	( )	( )	( )
Is the individual ready for promotion at this time?	( )	( )	( )	( )	( )
Supervisory Capabilities					
Does the individual demonstrate the ability to direct and be responsible for the performance of others?	( )	( )	( )	( )	( )
Does the individual effectively evaluate and develop subordinates?	( )	( )	( )	( )	( )
Are subordinates properly motivated?	( )	( )	( )	( )	( )
Are subordinates given reasonable goals and aided in meeting them?	( )	( )	( )	( )	( )
Does the individual comply with administrative and policy guidelines of ?	( )	( )	( )	( )	( )
Is good judgment excercised in observing budget constraints?	( )	( )	( )	( )	( )
Does the individual maintain adequate discipline in regard to subordinates attendance and punctuality?	( )	( )	( )	( )	( )
Does the individual provide a good example for peers and subordinates to follow?	( )	( )	( )	( )	( )

INCUMBENT REVIEW COMMENTS & ACKNOWLEDGEMENT
I acknowledge that: (1) I have reviewed and discussed this performance appraisal with the preparer. My signature means that I have been advised of my performance evaluation but does not necessarily imply that I agree with it; (2) I have received a copy of the goals/duties that will be used to evaluate my performance during the coming year; and (3) I have reviewed my job description and do ☐ do not ☐ feel it should be revised. My signature and the date I discussed this with the preparer appears below.

Employee	Date
Evaluator/Title	**Date**

.18 New Client Acceptance Checklist

Name of prospective client: ____________________

Address and Phone No.: ____________________

____

Name and title of contact at prospective client: ____________________

____

Form completed by: ____________________ Date: ____________________

Instructions

This form provides for information necessary to assess whether to accept a prospective client. The information should be obtained from discussions with the prospective client's management, banker, attorney, and if applicable current or former independent CPA, from reviewing the client's financial statements and tax returns, and from other sources such as industry or accounting journals, etc. As much information as possible should be obtained before visiting the potential client. Depending on the type of engagement involved, some information requested on this form may not be applicable, or additional information may be necessary and should be attached.

Services and Reports Required

1. Describe the service and reports requested. ____________________

2. Describe the reason the service is needed, including any regulatory requirements or third parties for which the service or report is intended. ____________________

3. What is the required completion date? ____________________

4. Describe any other services not requested for which there appears to be a need. ____________________

Industry Practices and Conditions

5. In what industry does the company operate? ____________________

6. Describe any specialized tax or accounting practices applicable to the industry. ____________________

7. Describe any economic, technological or competitive conditions or other recent developments in the industry that may affect the company's operations. ____________________

8. Describe any special regulatory requirements applicable to the industry. ____________________

Organization and Personnel

9. Company's Legal Name: ____________________ Fiscal Year End: ____________________

10. Type of legal entity (Corporation, S Corporation, partnership, proprietorship, etc.): ____________________

11. List the major stockholders (partners or owners) of the company and their percentage of ownership. If applicable, obtain and attach a copy of the company's organization chart.

Name and (if applicable) Title	% Ownership

12. List the principal members of management.

Name and Title	Stated Qualifications (education, training, and experience)

13. Briefly describe any existing or contemplated employee bonus arrangement (individual, title, method of computation), stock option, or pension (profit sharing) plans that may affect the engagement.

14. List each location maintained by the company (including foreign locations, if any) the nature of the activity performed at each, and the approximate number of employees at each, i.e., plant, sales office, executive offices, etc.

Location	Activity	No. of Employees

15. Inquire about possible transactions with related parties that may affect the engagement.

Name of Related Party	**Relationship**	**Type of Transaction**

Operations

16. Describe the nature of the company's major assets and liabilities.

17. What are the company's sources of revenue and marketing methods? Describe major products, customers, etc.)

18. If the company is economically dependent on a major customer, name the customer and approximate percentage of total revenue generated by this customer.

19. Describe the components of cost of goods sold and the company's production process.

20. What are the major expenses of the company other than cost of goods sold? ______

21. Describe the company's compensation methods, i.e., salary, hourly wage, commissions, piece work, union scale, etc. ______

22. What are the company's major sources of financing, i.e., working capital loans, long term debt, leasing, equity, etc. Describe restrictive covenants on any loan agreements. ______

Accounting

23. Does the company maintain the following items? [Attach description, if appropriate.]
    a. Accounting manual? ______
    b. Budget? ______
    c. Cost accounting system? ______
    d. EDP equipment? (indicate type of equipment and software) ______
    e. Written credit policy? ______

24. Briefly describe the accounting system and accounting responsibilities.

Description of Accounting Record	Name of person who is responsible	EDP	MANUAL	N/A
General Ledger				
Subsidiary Ledgers:				
Accounts receivable				
Fixed assets				
Loans payable				
Accounts payable				
Perpetual inventory				
Physical inventory summarization				
Journals:				
Cash receipts				
Cash disbursements				
Sales/purchase/voucher				
Payroll				
General journal entries				
Financial Reporting [Indicate basis of accounting]:				
Annual financial statements				
Monthly financial statements				
Management reports				
Other:				
Bank reconciliations				

25. Describe the company's completeness procedures and methods to insure that accounting transactions enter into the accounting system, i.e., that all shipments or services are invoiced, that all cash sales are recorded, and that all disbursements are recorded.

26. Describe any unusual features of the accounting system.

27. For audit engagements, does it appear that the accounting system provides accounting records sufficient to permit the application of audit procedures on a cost-effective basis? [If no, attach a memo explaining the possible scope limitation, its potential effect on the auditor's report, and the potential management's reaction.]

Tax Matters

28. Who prepares the tax returns?________________

29. Describe major differences between book and tax income, unusual tax elections, carry forwards or IRS examinations in process. If possible, review copies of the most recent 3 years of tax returns and attach them to this form.________________

Other Matters

30. Describe any significant problems that could affect the engagement, such as litigation or other contingencies, unusual agreements, and plans to acquire or dispose of signifcant assets, merge with another entity, enter a new area of business, convert to or expand use of EDP equipment, etc.________________

31. Give the name of a current or former independent CPA.________________

    a. Describe any disputes over accounting matters.________________

32. Describe any apparent problems or areas for improvement that were noted where our firm could provide additional service or recommendations.________________

Independence

33. Would service to this client cause problems of independence or conflicts of interest because of relationships with other clients or members of the staff?________________

Fees

34. Based on inquiries with a current or former independent CPA, if applicable, indicate the amount of any unpaid fees and the reason for nonpayment.________________

35. If possible indicate the amount of fees charged by an existing or former independent CPA for the service being proposed. (The CPA or the potential client may be willing to furnish this information, or it might be obtainable from the financial statements or tax return.)________________

36. Describe any other indications that our firm might have a problem billing or collecting our fees.________________

Management Integrity

37. Have any of the following sources raised any concerns about management's integrity?

    a. Difficulty in obtaining information from management, or evasive, guarded or glib responses to inquiries.________________

    b. Apparent difficulty in meeting financial operations or a deteriorating financial position that might predispose management to make an intentional error, irregularity or misrepresentation.

    c. Disputes about accounting principles, engagement procedures or similarly significant matters with an existing or former accountant, or doubts of the predecessor accountant about management's integrity.________________

d. Comments by bankers, attorneys, creditors, or others having a business relationship with the potential client.______

38. If management is changing accountants, why is the change being made?______

39. Is there any reason to suspect that management would be uncooperative, unreasonable or otherwise unpleasant to work with?______

Other Comments or Observations

40. Give any other comments or observations that might affect our decision whether to prepare a proposal letter or its contents. Add attachments to this form, if necessary.______

.19 Client Evaluation Questionnaire *

CONFIDENTIAL

Client________________________ Account Director________________________

Date________________

[Circle only one number in each group.]

What is usual condition of client's records?

2 Unusable or always late
4 Scattered but workable
6 Client needs orientation
8 Good
10 Excellent

What is client's potential growth?

5 Terminating
10 Decreasing
15 Level
20 Growing
25 Unlimited

What is client's attitude toward IRS?

1 Apprehensive
2 Hostile
5 Apathetic
8 Cooperative

What work is done for client?

3 Bookkeeping
6 Unaudited reports
9 Opinion audits
12 Year-end work and special services
15 Comprehensive services

Does client pay fees on time?

1 May never pay
2 Always 90 days late
5 Pays within 45 days
10 Pays when billed

How does client react to fees?

1 Fees always challenged as too high
5 Requires itemized bill
10 Usually accepts amount of bill
15 Wants service and expects to pay
20 Thinks we are superior—pays premium

What is the total annual fee?

3 To $1,500
6 $1,500—$5,000
9 $5,000—$10,000
12 Above $10,000

What is client's attitude toward recommending us?

1 Would never do so
2 Might do so
12 Has not recently
16 Does at times
20 Does frequently

What does client want from us?

1 Minimum service
2 Security regarding IRS
3 Counseling
4 Timely service
5 Direction and tax planning

From whom does client seek information?

1 His employees
2 News media
3 His competitors
4 His friends
5 Professionals (including us)

What is client's attitude toward his expenses?

1 Spendthrift
2 Niggardly
3 Economical
4 Liberal
5 Goes "first class"

Does client expose us to legal action?

1 High risk
2 Would consider suit
3 Low risk
4 Little risk
5 Would never sue

* This form should be used to determine if the firm should continue its involvement with a client.

What is client's attitude toward our staff?		**What is client's financial strength?**	
1	Critical and argumentative	1	Insolvent
2	Uncooperative	4	Solvent but undercapitalized
3	Usually cooperative	8	Adequate
4	Businesslike	10	Strong capital structure
5	Friendly and appreciative		

Above conditions prevailed at month of____________________

Evaluation by____________________

Scoring:

Maximum = 154 points
Minimum = 23 points
30 points and below = Drop client
30 to 50 points = Evaluate in 90 days (on trial)
50 to 70 points = Make an attempt to upgrade client
70 points and above = Retain client

Total Points____________________

Make additional comments on back.

.20 Summary Inspection Report

I. *Planning the Inspection*

A. Inspection period ______

B. Composition of Inspection Team:

1. Captain ______ Position ______
2. Team Member ______ Position ______
3. Team Member ______ Position ______

C. Indicate matters that may require additional emphasis in the inspection and explain why.

______

______

______

______

______

D. Development of Inspection Program:

1. Describe programs used and indicate any deviations therefrom.

______

______

______

______

2. Describe basis for selection of engagements:

______

______

______

E. Timing of Inspection:

Commencement ______

Completion of field work ______

Issuance of report ______

II. *Scope of Work Performed*

A. Indicate elements of quality control not addressed and give reasons.

______

______

______

______

B. Engagements Reviewed:

	Firm Totals		Engs. Reviewed	
	Hrs.	No. of Engs.	Hrs.	No. of Engs.
Audits:				
SEC Clients				
Government[1]				
Other				
Reviews				
Compilations				
Other Accounting Services				
Percentage of A&A Practice Reviewed				

Comments: ____

____

____

III. *Engagement Conclusions*

A. Did the inspection disclose any situation that led the reviewers to conclude that the firm or office should consider:

1. Taking action to prevent future reliance on a previously issued report, pursuant to SAS No. 1 (AU section 561)? Yes ________ No ________

2. Performing additional auditing procedures to provide a satisfactory basis for a previously expressed opinion, pursuant to SAS No. 46 (AU section 390)? Yes ________ No ________

B. Did the inspection team conclude in any instances that the firm or office lacked a reasonable basis under the standards for accounting and review services for the report issued? Yes ________ No ________

If any of the answers above are yes, attach a description of such situations, including actions the firm or office has taken or plans to take.

IV. *Findings and Recommendations*:

Attach a copy of any reports issued, including a summary of any inspection findings and recommendations for improvement or list such findings and recommendations below.

____

____

____

____

____

____

____

Supervisory Partner ________________________

Date ________________________

[1] Includes only audits conducted pursuant to the *Government Auditing Standards,* issued by the Comptroller General of the United States ("yellow book").

.21 Inspection of Compliance With Policies and Procedures Relating to the Elements of Quality Control

Period Covered	Yes	No	N/A	Extent of Testing
INDEPENDENCE				
1. Have memorandums of inquiry, written representations, or other appropriate documentation been obtained, evidencing:				
a) Communication of firm policies and procedures relating to independence?	___	___	___	___
b) Monitoring of compliance with those policies and procedures?	___	___	___	___
2. Have independence questions which have arisen been appropriately resolved and, where necessary, have appropriate authorities been consulted?	___	___	___	___
ASSIGNING PERSONNEL TO ENGAGEMENTS				
1. Have the firm's policies and procedures been followed to provide reasonable assurance that personnel are assigned to engagements in a manner that attempts to achieve a balance between the complexity of the engagement, the qualifications of the staff and individual development?	___	___	___	___
CONSULTATION				
1. Does the firm's reference library contain technical manuals, and recent pronouncements, including those relating to particular industries and other specialties, that meet the needs of the practice?	___	___	___	___
2. On engagements reviewed, was consultation performed and documented in accordance with firm policy?	___	___	___	___
3. If sufficient testing of consultation policies and procedures was not performed in 2 above, were consultations that took place appropriately and correctly applied? (This may be accomplished through inquiry or review of the subject files.)	___	___	___	___
SUPERVISION				
1. On engagements reviewed, have the required technical materials, (audit manuals, standarized forms, checklists and questionnaires) been used?	___	___	___	___
2. Based on the engagements reviewed:				
a) Are the technical materials sufficiently comprehensive and up-to-date?	___	___	___	___
b) Are the firm's policies and procedures for the review of engagement working papers, reports and financial statements appropriate?	___	___	___	___

Period Covered	Yes	No	N/A	Extent of Testing
c) Are the firm's procedures for resolving differences of opinion among members of the engagement team appropriate?	___	___	___	___
PROFESSIONAL DEVELOPMENT				
1. Do the firm's professional development records meet the requirements of the firm and of the Section?	___	___	___	___
2. Has the professional development program for the last year been reviewed to determine if it fulfills the firm's needs for personnel with expertise in specialized areas and industries?	___	___	___	___
HIRING				
1. Has the firm planned for its personnel needs in accordance with its policies and procedures?	___	___	___	___
2. Does the firm's hiring program satisfy its needs?	___	___	___	___
3. Do personnel files of recently hired employees contain appropriate evidence that the individuals meet the firm's personal, educational, and experience requirements?	___	___	___	___
4. Have new personnel been notified of the policies and procedures that apply to them?	___	___	___	___
ADVANCEMENT				
1. Based on a review of personnel files, personnel evaluations, or other documentary evidence, have personnel been evaluated and promoted in accordance with the firm's policies and procedures?	___	___	___	___
ACCEPTANCE AND CONTINUANCE OF CLIENTS				
1. Do new client files contain documentation of compliance with the firm's policies and procedures for acceptance of clients?	___	___	___	___
2. On engagements reviewed, was the firm's policy for continuance of clients, including required documentation, complied with?	___	___	___	___
INSPECTION				
1. Were appropriate corrective actions taken, including effective follow-up, with respect to the prior period's inspection findings?	___	___	___	___

______________________________ Reviewer ______________________________ Date

______________________________ Supervisory Partner ______________________________ Date

AAM

APPENDIXES

Pronouncements cited in the Audit and Accounting Manual are cross-referenced to sections in the text

TABLE OF CONTENTS

Cross-References

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Accounting Research Bulletins

No.	Chap.	Par.	Sec.
43	2	1	2400.05
	4	. . .	6500.290

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Accounting Principles Board Opinions

No.	Par.	Sec.	
17	. . .	8010.13	
20	13	10,260.150	
21	. . .	5400.070	(VII)A8h(6)
	. . .	5400.075	(VIII)A5a
	. . .	8110.19	
	. . .	9210.030	(II)B12
22	. . .	8040.76	
	. . .	8160.13	
	. . .	8160.42	
25	. . .	8200.19	
29	. . .	8050.83	
30	. . .	8010.10	
	. . .	8010.125	
	. . .	8015.66	
	. . .	8080.33	
	. . .	8160.50	
	14	8010.10	

[The next page is 20,051.]

Statements on Auditing Standards

No.	Sec.	Par.	Sec.	
1	331	. . .	8010.94	
		14	5400.080	(IX)A1f
		15	5400.080	(IX)A1f
	420	11	10,210.220	
	530	. . .	8010.69	
		. . .	8010.103	
		. . .	8190.52	
		. . .	10,100.10	
	543	. . .	3115.06	
		. . .	8110.03	
		16	10,210.080	
	561	. . .	2300.13	(15)
		. . .	2300.18	(20)
		. . .	2400.14	
		. . .	2400.16	
		. . .	8015.26	
		6a	10,210.240	
7		. . .	5400.030	
		. . .	5600.010	
		. . .	8010.58	
		4	3130.09	
8		. . .	8010.59	
		. . .	8010.60	
		. . .	8040.78	
		. . .	8120.20	
		. . .	8160.51	
		. . .	8200.20	
		. . .	8210.24	
11		. . .	3120.04	
		. . .	5400.080	(IX)A1d
		. . .	8010.19	
		. . .	8010.29	
		. . .	8010.52	
		. . .	8010.130	
		. . .	8010.145	
		. . .	8020.23	
		. . .	8040.08	
		. . .	8060.24	
		. . .	8080.16	
		. . .	8120.09	
		. . .	8160.15	
		. . .	8160.27	
		. . .	8180.28	
		. . .	8210.34	
		9	9210.150	(II)N2
		10	9210.150	(II)N2

Statements on Auditing Standards—continued

No.	Sec.	Par.	Sec.	
11		11	9210.150	(II)N2
		12	9210.150	(II)N2
12		. . .	5400.180	(XXIX)A6
		. . .	7300.01	
		. . .	8010.29	
		. . .	8010.98	
		. . .	8010.99	
		. . .	9210.010	(I)A11
		5	6500.650	
		6	6500.650	
		7	6500.650	
		10	7300.03	
19		. . .	5400.030	(I)B3
		. . .	5400.190	(XXX)A6
		. . .	6500.650	
		. . .	7400.01	
		. . .	8010.112	
		. . .	9210.010	(I)A14
		4	8015.10	
		5	7400.01	
		12	5100.35	
22		. . .	3100.03	
		. . .	5300.09	
		. . .	8010.96	
		. . .	8010.109	
		. . .	8010.118	
		. . .	8020.19	
		. . .	8040.40	
		. . .	8050.12	
		. . .	8050.77	
		. . .	8060.24	
		. . .	8080.23	
		. . .	8100.08	
		. . .	8110.10	
		. . .	8140.07	
		. . .	8150.08	
		. . .	8150.28	
		. . .	8170.08	
		. . .	8170.30	
		. . .	8180.23	
		. . .	8180.28	
		. . .	8210.07	
		. . .	9100.06	
		. . .	9210.010	(I)A2
		. . .	9210.010	(I)A7
		. . .	9230.010	(I)A1a
26		5	2100.02	
		5	10,270.01	

Statements on Auditing Standards—continued

No.	Sec.	Par.	Sec.	
26		5	10,270.02	
		7	10,270.03	
		7	10,270.04	
		8	3115.07	
		8	3165.03	
		9	3115.07	
		9	3165.03	
		10	3115.07	
		10	3165.03	
		10	10,280.01	
		16	10,270.02	
		17	10,210.170	
		17	10,210.180	
		17	10,210.190	
29		. . .	8010.59	
		. . .	8010.60	
		13	10,245.060	
		13	10,245.070	
		14	10,245.080	
		18	10,245.100	
30		. . .	4200.26	
		. . .	4200.27	
		. . .	8010.47	
		. . .	8050.43	
		. . .	8050.44	
		. . .	8090.07	
		. . .	8110.09	
		. . .	8190.52	
31		. . .	4700.01	
		. . .	4700.02	
		. . .	5100.05	
		. . .	5100.26	
		. . .	5100.34	
		. . .	5100.36	
		5	5100.27	
		9	9210.010	(I)A7b
		10	9210.010	(I)A7b
		11	5100.39	
		11	9210.010	(I)A7b
		12	5100.08	
		12	9210.010	(I)A7b
		13	9210.010	(I)A7b
		22	5100.32	
32		. . .	8010.120	
35		. . .	2600.06	
		. . .	8010.35	
		. . .	8010.77	
		. . .	8010.78	

Statements on Auditing Standards—continued

No.	Sec.	Par.	Sec.	
35		. . .	8010.79	
		. . .	8010.80	
		. . .	8010.81	
		. . .	8030.39	
		. . .	8180.36	
		. . .	9240.140	(II)G3
		6	10,260.080	
		6	10,260.090	
39		. . .	5300.02	
		. . .	5300.03	
		. . .	5300.04	
		. . .	5300.05	
		. . .	5300.06	
		. . .	5300.07	
		. . .	5300.09	
		. . .	5300.18	
		. . .	5300.26	
		. . .	5300.28	
		. . .	5300.34	
		. . .	5300.35	
		. . .	5300.38	
		. . .	9100.06	
		. . .	9210.010	(I)A21
		1	5300.12	
		15	9210.010	(I)A9
		15	9230.010	(I)A2
		16	9230.010	(I)A9
		16	9230.010	(I)A2
		17	9210.010	(I)A9
		17	9230.010	(I)A2
		18	5300.08	
		18	9210.010	(I)A9
		18	9230.010	(I)A2
		19	9210.010	(I)A9
		19	9230.010	(I)A2
		20	9210.010	(I)A9
		20	9230.010	(I)A2
		21	5300.08	
		21	9210.070	(I)A9
		21	9230.010	(I)A2
		22	5300.08	
		22	9210.010	(I)A9
		22	9230.010	(I)A2
		23	5300.33	
		23	9210.010	(I)A9
		23	9230.010	(I)A2
		24	5300.08	
		24	9210.010	(I)A9

Statements on Auditing Standards—continued

No.	Sec.	Par.	Sec.	
39		24	9230.010	(I)A2
		25	5300.08	
		25	9210.010	(I)A9
		25	9230.010	(I)A2
		26	5300.08	
		26	9210.010	(I)A9
		26	9230.010	(I)A2
		27	9210.010	(I)A9
		27	9230.010	(I)A2
		28	9210.010	(I)A9
		28	9230.010	(I)A2
		29	9210.010	(I)A9
		29	9230.010	(I)A2
		30	5300.08	
		30	9210.010	(I)A9
		30	9230.010	(I)A2
		31	9210.010	(I)A8
		32	9210.010	(I)A8
		33	9210.010	(I)A8
		34	9210.010	(I)A8
		35	9210.010	(I)A8
		36	9210.010	(I)A8
		37	9210.010	(I)A8
		38	9210.010	(I)A8
		39	9210.010	(I)A8
		40	9210.010	(I)A8
		41	9210.010	(I)A8
		42	9210.010	(I)A8
41		...	5300.09	
		...	6100.01	
		...	8010.31	
		...	8010.115	
		...	8010.117	
		...	8010.121	
		...	8190.54	
		...	9100.06	
		1	8010.117	
		3	5400.240	(VI)B1f
		5	9230.120	(III)A7e
42		1a	10,550.01	
		6	10,550.01	
		7	10,550.02	
		8	10,550.03	
		10	10,245.110	
43		3	5400.080	(IX)A1f
44		...	8010.39	
		...	8030.37	
		...	8060.30	

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No.	Sec.	Par.	Sec.	
44		. . .	8060.32	
		. . .	8080.24	
		. . .	8160.29	
		. . .	8170.32	
45		. . .	5200.09	
		. . .	5200.10	
		. . .	5200.400	(XIV)B3
		. . .	5400.160	(XXV)A5
		. . .	5400.165	(XXVI)A5
		. . .	8010.94	
		. . .	8020.21	
		. . .	8030.44	
		. . .	8040.49	
		. . .	8100.24	
		. . .	8210.22	
		. . .	9210.010	(I)A7d
		. . .	9210.150	(II)N3
46		. . .	11,600.20	(III)A
47		. . .	3140.02	
		. . .	3140.04	
		. . .	3140.14	
		. . .	8010.108	
		. . .	9210.010	(I)A15
		. . .	9210.150	(II)N4
		3	3140.17	
48		. . .	6500.690	
		. . .	8110.10	
		. . .	9200.040	(IV)H
		. . .	9210.010	(I)A4d
49		. . .	8010.36	
		. . .	8030.40	
		. . .	8070.34	
50		. . .	8010.61	
		. . .	8010.62	
		9	10,260.150	
51		. . .	8010.64	
		10	10,210.200	
		14	10,210.210	
		15	10,210.210	
52		. . .	8010.59	
		. . .	8010.60	
		. . .	8160.35	
		. . .	9210.150	(II)N1
		2	10,245.010	
		2	10,245.015	
		2	10,245.020	
		2	10,245.025	

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No.	Sec.	Par.	Sec.	
52		2	10,245.030	
		2	10,245.035	
		2	10,245.040	
		2	10,245.045	
		2	10,245.090	
		2	10,245.095	
		3	10,245.050	
		3	10,245.090	
		3	10,245.095	
53		. . .	3150.05	
		. . .	5100.34	
		. . .	7400.01	
		. . .	8010.87	
		. . .	9210.010	(I)A2e
		. . .	9210.010	(I)A16
		. . .	9210.010	(I)A22
		8	5100.33	
		12	3125.16	
		16	3125.16	
54		. . .	8010.29	
		. . .	8030.20	
		. . .	8060.17	
		. . .	8070.06	
		. . .	8070.23	
		. . .	8070.41	
		. . .	8100.08	
		. . .	8100.21	
		. . .	8110.54	
		. . .	8130.06	
		. . .	8130.35	
		. . .	8140.07	
		. . .	8150.08	
		. . .	8170.08	
		. . .	8180.23	
		. . .	8180.34	
		. . .	8210.07	
		. . .	9100.06	
		. . .	9210.010	(I)A16
		17	3125.16	
55		. . .	3125.05	
		. . .	4100.01	
		. . .	4100.03	
		. . .	4200.24	
		. . .	4200.27	
		. . .	4700.03	
		. . .	5100.10	
		. . .	5400.040	(II)H1c
		. . .	5400.040	(II)L1c

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No.	Sec.	Par.	Sec.	
55		. . .	5400.040	(II)P1c
		. . .	8010.38	
		. . .	8010.48	
		. . .	8010.110	
		. . .	8040.19	
		. . .	8100.29	
		. . .	8110.14	
		. . .	8140.23	
		. . .	8150.30	
		. . .	8150.38	
		. . .	8170.33	
		. . .	8190.52	
		. . .	8200.04	
		. . .	9210.010	(I)A2d
		. . .	9210.010	(I)A4
		. . .	9210.010	(I)A7a
		. . .	9230.120	(III)A5a
		. . .	9230.120	(III)A6
		8	4100.02	
		69	8050.67	
		69	8190.52	
56		. . .	3120.05	
		. . .	5100.17	
		. . .	5400.030	(I)A8b
		. . .	5400.030	(I)B6b
		. . .	5400.070	(VII)A3
		. . .	5400.070	(VII)A10b(5)
		. . .	5400.075	(VIII)A9
		. . .	5400.080	(IX)G1b
		. . .	5400.090	(XI)A15
		. . .	5400.095	(XII)A6
		. . .	5400.120	(XVII)A7
		. . .	5400.125	(XVIII)A7
		. . .	5400.160	(XXV)A3b
		. . .	5400.165	(XXVI)A46
		. . .	5400.170	(XXVII)A2
		. . .	5400.170	(XXVII)A2b
		. . .	5400.170	(XXVII)A2d
		. . .	5400.170	(XXVII)A2e
		. . .	5400.175	(XXVIII)A3
		. . .	5400.175	(XXVIII)A3b
		. . .	6500.050	
		. . .	6500.690	
		. . .	8010.111	
		. . .	9100.06	
		. . .	9210.010	(I)A10
57		. . .	5400.070	(VII)A10b
		. . .	5400.075	(VIII)A8b
		. . .	5400.120	(XVII)A8b

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No.	Sec.	Par.	Sec.	
57		. . .	5400.125	(XVIII)A8b
		. . .	8010.29	
		. . .	8010.130	
		. . .	8010.135	
		. . .	8010.143	
		. . .	8010.145	
		. . .	8020.23	
		. . .	8030.42	
		. . .	8040.20	
		. . .	8040.30	
		. . .	8050.91	
		. . .	8060.04	
		. . .	8100.23	
		. . .	8120.08	
		. . .	8140.11	
		. . .	8180.26	
		. . .	8200.16	
		. . .	8210.34	
58		. . .	8010.67	
		. . .	8010.69	
		. . .	8040.26	
		8	10,210.010	
		8	10,210.020	
		8	10,210.220	
		8	10,210.230	
		8	10,210.240	
		9	10,100.05	
		13	10,210.050	
		24	10,700.11	
		25	10,700.11	
		26	10,700.11	
		27	10,700.11	
		28	10,700.11	
		29	10,700.11	
		30	10,700.11	
		32	10,210.100	
		34	8010.136	
		34	10,240.060	
		35	10,210.090	
		35	10,240.060	
		36	10,240.060	
		37	10,210.230	
		42	3130.08	
		44	10,230.01	
		44	10,240.010	
		44	10,240.080	
		48	10,210.030	
		48	10,210.031	
		49	8080.30	

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No.	Sec.	Par.	Sec.
58		50	8080.30
		51	8080.30
		52	8080.30
		53	8080.30
		53	10,240.020
		53	10,240.080
		53	10,245.080
		54	8080.30
		54	10,240.030
		55	8080.30
		56	8080.30
		56	10,240.040
		57	8080.30
		58	8080.30
		58	10,240.050
		59	8080.30
		60	8080.30
		61	8080.30
		61	10,240.060
		62	8080.30
		63	8080.30
		64	8080.30
		64	10,240.070
		65	8080.30
		66	8080.30
		67	8080.30
		68	8080.30
		69	8080.30
		69	10,220.01
		72	10,230.02
		72	10,230.03
		74	10,100.10
		76	10,210.150
		78	10,210.160
		82	10,100.10
		83	10,210.040
		83	10,210.060
		83	10,210.070
		83	10,210.083
		83	10,210.084
		83	10,210.085
		83	10,210.086
59		. . .	8010.05
		. . .	8010.06
		. . .	8030.04
		. . .	8030.06
		. . .	8030.14
		. . .	8030.48
		. . .	8040.15

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No.	Sec.	Par.	Sec.	
59		. . .	8050.89	
		. . .	8070.08	
		. . .	8070.59	
		. . .	8100.06	
		. . .	8100.22	
		. . .	8110.05	
		. . .	8190.25	
		. . .	8210.27	
		10	2500.28	
		10	8015.05	
		11	2500.28	
		11	8015.05	
		12	10,700.11	
		13	10,210.110	
		13	10,700.11	
		14	10,700.11	
		15	10,700.11	
		16	10,700.11	
60		. . .	3130.11	
		. . .	3165.07	
		. . .	4100.03	
		. . .	4200.19	
		. . .	4200.23	
		. . .	4200.25	
		. . .	5400.030	(I)B2
		. . .	5400.040	(II)D1
		. . .	8010.113	
		. . .	8040.21	
		. . .	8200.04	
		. . .	9210.010	(I)A17
		. . .	9210.010	(I)A19
		. . .	9220.130	(III)A8b
		. . .	9230.010	(I)A14b
		12	10,250.110	
		12	10,250.120	
		16	10,250.120	
		17	10,250.110	
		17	10,250.120	
		17	10,700.28	
61		. . .	5400.030	(I)A21
		. . .	7500.01	
		. . .	8010.114	
		. . .	9210.010	(I)A30
62		. . .	8010.74	
		. . .	8070.11	
		. . .	8180.13	
		4	2100.05	
		7	2100.05	

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No.	Sec.	Par.	Sec.	
62		7	8015.42	
		8	10,260.010	
		8	10,260.020	
		8	10,260.030	
		8	10,600.07	
		9	8015.05	
		9	8015.42	
		10	8015.05	
		10	8015.42	
		18	10,260.040	
		18	10,260.050	
		18	10,260.060	
		18	10,260.070	
		21	10,260.110	
		21	10,260.120	
		26	10,260.140	
		26	10,260.141	
		30	10,260.130	
		30	10,260.131	
65		...	5400.030	
		...	8190.52	
		...	9210.010	(I)A5
		...	9210.010	(I)A20
67		...	8010.100	
		...	8110.07	
		...	8170.24	
68		...	5610.01	
		...	8030.35	
		...	8070.29	
		...	8070.30	
		...	8070.31	
		...	8180.34	
69		...	2100.05	
		...	3105.02	
		...	3105.03	
		...	3105.06	
		...	8010.42	
		...	8010.45	
		...	8010.46	
		...	8015.05	
		...	8015.57	
		...	8015.59	
		...	8015.61	
		...	8015.62	
		...	8070.62	
		...	8070.63	
		4	2600.04	
		6	2600.06	

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No.	Sec.	Par.	Sec.	
70		. . .	3120.05	
		. . .	8010.39	
		. . .	8010.41	
		. . .	8020.28	
		. . .	8020.29	
		. . .	8020.32	
		. . .	8030.37	
		. . .	8050.96	
		. . .	8060.30	
		. . .	8060.32	
		. . .	8060.34	
		. . .	8080.24	
		. . .	8140.23	
		. . .	8150.29	
		. . .	8150.30	
		. . .	8150.39	
		. . .	8170.32	
		. . .	8170.33	
		. . .	8190.52	
		. . .	9210.010	(I)A4d
		. . .	9210.010	(I)A4e
		38	10,250.130	
		54	10,250.140	
71		. . .	2100.14	
		. . .	8010.35	
		. . .	8010.36	
		. . .	8015.03	
		. . .	8030.39	
		. . .	8180.36	
		. . .	10,300.01	
		27	10,300.01	
		28	10,300.01	
72		. . .	8010.35	
		. . .	8010.36	
		. . .	8030.39	
		. . .	8030.40	
		. . .	8070.34	
		. . .	8180.36	
		6	8010.35	
		6	8180.36	
		7	8010.36	
		7	8180.36	
73		. . .	8180.28	

[The next page is 20,111.]

Statements on Standards for Attestation Engagements

No.	Sec.	Par.	Sec.
1	100	. . .	8010.47
	100	. . .	8010.77
	100	. . .	8010.80
	100	. . .	8010.81
	100	. . .	8150.43
	100	. . .	8190.12
	100	. . .	8190.52
	200	. . .	2100.05
	200	. . .	8010.47
	200	. . .	8010.77
	200	. . .	8010.81
	200	. . .	8190.12
	200	. . .	8190.52
	200	58	10,400.22
	200	58	10,400.23
	300	. . .	8010.47
	300	. . .	8190.12
	300	. . .	8190.52
2	400	. . .	4100.04
	400	. . .	4200.26
	400	. . .	8010.47
	400	. . .	8010.48
	400	. . .	8010.49
	400	. . .	8050.44
	400	. . .	8050.58
	400	. . .	8050.63
	400	. . .	8050.67
	400	. . .	8050.69
	400	. . .	8150.41
	400	. . .	8150.42
	400	. . .	8170.36
	400	. . .	8170.37
	400	. . .	8190.12
	400	. . .	8190.52
	400	. . .	10,250.150
	400	. . .	10,250.160
	400	2	8190.52
	400	27	8050.67
	400	27	8190.52
	400	51	10,250.010
	400	54	10,250.020
	400	58	10,250.030
	400	60	10,250.040
	400	64	10,250.050
	400	66	10,250.060
	400	68	10,250.070

Statements on Standards for Attestation Engagements—continued

No.	Sec.	Par.	Sec.
2	400	72	10,250.080
	400	74	10,250.090
	400	77	10,250.100
	400	84	8190.52
	400	85	8190.52
	400	86	8190.52
	400	87	8190.52
3	500	. . .	8010.51

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Audit and Accounting Guides

Name of Guide	Sec.
Audit Sampling	5300.32
	5300.35
	5300.39
	5610.01
Audits of Agricultural Producers and Cooperatives	8080.35
Audits of Airlines	8090.18
Audits of Banks	8040.30
	8050.35
	8050.77
	8050.91
	8140.11
Audits of Brokers and Dealers in Securities	8170.26
	8170.37
	8170.38
Audits of Certain Nonprofit Organizations	8180.44
	8180.45
	8180.48
Audits of Colleges and Universities	8180.33
	8180.44
	8180.45
	8180.48
Audits of Credit Unions	8020.23
	8020.27
	8040.30
	8140.11
Audits of Employee Benefit Plans	5610.01
	8060.16
	8060.25
	8060.26
	8060.27
	8060.28
	8060.29
	8060.35
	8060.40
	8060.41
	10,800.01
	10,800.02

[The next page is 20,121-3.]

Audit and Accounting Guides—continued

Name of Guide	Sec.
Audits of Employee Benefit Plans—continued	10,800.03
	10,800.04
	10,800.05
	10,800.06
	10,800.07
	10,800.08
	10,800.09
	10,800.10
	10,800.11
	10,800.12
	10,800.13
	10,800.14
	10,800.15
	10,800.16
	10,800.17
	10,800.18
	10,800.19
	10,800.20
	10,800.21
	10,800.22
Audits of Entities With Oil and Gas Producing Activities	8160.52
Audits of Federal Government Contractors	8130.34
	8130.40
Audits of Finance Companies (Including Independent and Captive Financing Activities of Other Companies)	8140.08
Audits of Investment Companies	8150.09
	8150.15
	8150.19
	8150.24
	8150.34
	8150.35
	8150.44
	8150.48

Audit and Accounting Guides—continued

Name of Guide	Sec.
Audits of Property and Liability Insurance Companies	8040.46
	8040.48
Audits of Providers of Health Care Services	8030.34
	8030.42
	8030.58
	8180.48
Audits of Savings Institutions	8040.30
	8050.35
	8050.77
	8050.91
	8140.11
Audits of State and Local Governmental Units	5610.01
	8070.24
	8070.25
	8070.26
	8070.27
	8070.28
	8070.29
Audits of Voluntary Health and Welfare Organizations	8180.44
	8180.45

Audit and Accounting Guides—continued

Name of Guide	Sec.
Common Interest Realty Associations	8015.13
	8100.14
	8100.25
	8100.30
Computer-Assisted Audit Techniques	3120.05
Consideration of the Internal Control Structure in a Financial Statement Audit	5610.01
	8110.09
Construction Contractors	8015.12
	8120.08
	8120.21
Guide for Prospective Financial Statements	2100.05
Guide for the Use of Real Estate Appraisal Information	8020.23
	8040.30
	8050.91
	8140.11
	8210.18
Personal Financial Statements Guide	10,600.01
	10,600.02
	10,600.03
	10,600.04
	10,600.05
	10,600.06
	10,600.08
	10,600.09
	10,600.10
	10,600.11
	10,600.12
	10,600.13
	10,600.14
	10,600.15
	10,600.16
	10,600.17

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Statements of Position

Statements of Position—continued

No.	Title	Sec.
90-9	*The Auditor's Consideration of the Internal Control Structure Used in Administering Federal Financial Assistance Programs Under the Single Audit Act*	5610.01 9230.120
90-10	*Reports on Audited Financial Statements of Property and Liability Insurance Companies*	10,260.160
91-1	*Software Revenue Recognition*	8200.07
92-3	*Accounting for Foreclosed Assets*	8040.43 8210.21
92-4	*Auditing Insurance Entities' Loss Reserves*	8040.20
92-6	*Accounting and Reporting by Health and Welfare Benefit Plans*	8060.41 10,800.04 10,800.13
92-7	*Audits of State and Local Governmental Entities Receiving Federal Financial Assistance*	8030.36 8070.18 10,700.01 10,700.02 10,700.03 10,700.04 10,700.05 10,700.06 10,700.07 10,700.08 10,700.09 10,700.10 10,700.11 10,700.12 10,700.13 10,700.14 10,700.15 10,700.16 10,700.17 10,700.18 10,700.19 10,700.20 10,700.21 10,700.22 10,700.23 10,700.24 10,700.25 10,700.26 10,700.27 10,700.28 10,700.29 10,700.30 10,700.31 10,700.32 10,700.33

Statements of Position—continued

No.	Title	Sec.
92-8	*Auditing Property/Casualty Insurance Entities' Statutory Financial Statements—Applying Certain Requirements of the NAIC Annual Statement Instructions*	8040.50
92-9	*Audits of Not-for-Profit Organizations Receiving Federal Awards*	8030.33 8030.34 8030.35 8180.13
93-1	*Financial Accounting and Reporting for High-Yield Debt Securities by Investment Companies*	8010.157 8015.85 8150.35 8150.45
93-2	*Determination, Disclosure, and Financial Statement Presentation of Income, Capital Gain, and Return of Capital Distributions by Investment Companies*	8010.157 8015.85 8150.46
93-3	*Rescission of Accounting Principles Board Statements*	8010.157 8015.85
93-4	*Foreign Currency Accounting and Financial Statement Presentation for Investment Companies*	8010.157 8015.85 8150.06 8150.35 8150.47
93-5	*Reporting on Required Supplementary Information Accompanying Compiled or Reviewed Financial Statements of Common Interest Realty Associations*	8010.157 8015.85 8100.30
93-6	*Employers' Accounting for Employee Stock Ownership Plans*	8010.157 8015.85
93-7	*Reporting on Advertising Costs*	8015.85
93-8	*The Auditor's Consideration of Regulatory Risk-Based Capital for Life Insurance Enterprises*	8015.85

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Practice Bulletins

No.	Title	Sec.
1	*Purpose and Scope of AcSEC Practice Bulletins and Procedures for Their Issuance*	8210.23
7	*Criteria for Determining Whether Collateral for a Loan Has Been In-Substance Foreclosed*	8040.73

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Notice to Practitioners

Issue Date	Title	Sec.
2/91	*Audit, Review, and Compilation Considerations When a Predecessor Accountant Has Ceased Operations*	10,210.083 10,210.084 10,210.085 10,210.086 10,400.24 10,400.25 10,500.16 10,500.17
8/93	*Guidance for Independent Auditors When Required to Provide Access to or Photocopies of Workpapers to Regulators*	8010.32 8020.10 8030.46 8190.16
	Engagements to Report on Performance Presentation Standards of the Association for Investment Management and Research	8150.43

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Auditing Interpretations of Statements on Auditing Standards

Auditing Interpretation AU Sec.	AAM Sec.
9342.01—.10	8010.23
9337.18—.23	8010.99
9334.19	8030.45
9342.01—.10	8040.42
9339	8070.33
9342.01—.10	8120.14
9336.01—.03	8160.34
9642.01—.03	10,250.060
9642.01—.03	10,250.070
9623.30	10,260.130
9623.30	10,260.131
9623.36	10,260.140
9623.36	10,260.141

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Statements on Standards for Accounting and Review Services

No.	Par.	Sec.	
1	. . .	1200.08	
	. . .	1200.13	
	. . .	2100.02	
	. . .	2100.03	
	. . .	2100.05	
	. . .	2100.06	
	. . .	2100.07	
	. . .	2100.09	
	. . .	2100.11	
	. . .	2100.12	
	. . .	2100.15	
	. . .	2200.05	
	. . .	2200.17	
	. . .	2300.01	
	. . .	2300.12	
	. . .	2400.04	
	. . .	2500.10	
	. . .	2600.04	
	. . .	2600.06	
	. . .	7400.02	
	. . .	8015.03	
	. . .	8015.04	
	. . .	8015.05	
	. . .	8015.51	
	. . .	8015.57	
	. . .	8015.85	
	1	8015.03	
	3	9100.05	
	4	2100.04	
	4	8015.42	
	4	8015.48	
	5	8015.19	
	5	8015.24	
	6	2500.02	
	6	8015.06	
	7	8015.06	
	7	8015.45	
	8	2200.04	
	8	2300.14	(1)
	8	2300.19	(1)
	8	3130.01	
	8	8015.33	
	9	10,400.11	
	10	2300.14	(2)
	11	2300.14	(3)
	12	2300.14	(3)

Statements on Standards for Accounting and Review Services—continued

No.	Par.	Sec.	
1	12	2300.19	(11)
	12	10,400.12	
	13	2300.14	(4)
	14	2300.14	(14)
	14	2500.07	
	14	8015.30	
	14	8015.31	
	15	2300.14	(13)
	15	10,100.10	
	16	2300.14	(12)
	16	2400.03	
	17	10,400.01	
	17	10,400.04	
	17	10,400.12	
	17	10,400.13	
	17	10,400.14	
	17	10,400.15	
	17	10,400.16	
	17	10,400.22	
	17	10,400.23	
	17	10,400.24	
	17	10,400.25	
	19	2200.14	
	19	2300.14	(5)
	19	2300.14	(6)
	19	2500.18	
	19	8015.23	
	20	2300.14	(6)
	20	2500.18	
	20	8015.44	
	21	2300.14	(6)
	21	2500.18	
	21	10,400.02	
	21	10,400.03	
	22	2300.14	(9)
	22	2300.14	(10)
	22	10,400.04	
	24	2300.19	(4)
	24	2300.19	(6)
	26	2300.19	(5)
	27	2300.06	
	27	2300.10	
	27	2300.19	(6)
	27	2300.19	(7)
	27c	2300.08	
	29	2300.19	(8)
	30	2300.05	
	30	2300.19	(9)
	31	2300.19	(14)

Statements on Standards for Accounting and Review Services—continued

No.	Par.	Sec.	
1	31	7400.02	
	32	2300.19	(19)
	32	2500.12	
	32	8015.30	
	32	8015.32	
	33	2300.19	(18)
	33	10,100.10	
	34	2300.03	
	34	2300.19	(17)
	35	10,500.01	
	35	10,500.09	
	35	10,500.10	
	35	10,500.11	
	35	10,500.12	
	35	10,500.16	
	35	10,500.17	
	36	2200.15	
	36	2300.19	(10)
	36	2300.19	(11)
	36	2500.25	
	37	2500.16	
	38	2300.19	(2)
	38	2500.17	
	39	2100.07	
	39	2300.14	(7)
	39	2300.14	(8)
	39	2300.19	(12)
	39	2300.19	(13)
	40	2100.07	
	40	2300.14	(8)
	40	2300.19	(13)
	40	2500.23	
	40	10,400.05	
	40	10,400.06	
	40	10,400.21	
	40	10,500.02	
	40	10,500.03	
	40	10,500.04	
	40	10,500.15	
	41	2100.07	
	41	2200.08	
	41	2500.24	
	42	2200.08	
	42	2300.14	(15)
	42	2300.19	(20)
	42	2400.14	
	42	2400.16	
	42	8015.26	
	43	2200.08	

Statements on Standards for Accounting and Review Services—continued

No.	Par.	Sec.	
1	43	2300.14	(11)
	43	2300.19	(15)
	43	2300.19	(16)
	43	2400.10	
	43	8100.30	
	43	10,400.18	
	43	10,500.13	
	43	10,500.14	
	44	2200.08	
	44	2500.26	
	45	2200.08	
	45	2200.09	
	45	2500.26	
	46	2200.08	
	46	2500.26	
	47	2200.08	
	47	2500.26	
	48	2200.08	
	48	2200.12	
	48	2500.26	
	49	2200.08	
	49	2500.26	
	App. A	2300.07	
	App. B	8015.35	
	App. C	8015.35	
	App. D	8015.07	
	App. D	8015.08	
2	. . .	1200.09	
	. . .	2100.02	
	. . .	2100.05	
	. . .	2100.06	
	. . .	2100.15	
	. . .	2400.06	
	9	10,500.07	
	10	10,500.08	
	15	10,400.13	
	15	10,500.09	
	17	10,400.24	
	17	10,400.25	
	17	10,500.16	
	17	10,500.17	
	18	10,400.15	
	18	10,500.10	
	18	10,500.16	
	18	10,500.17	
	19	10,400.14	
	19	10,400.24	
	19	10,400.25	

Statements on Standards for Accounting and Review Services—continued

No.	Par.	Sec.
2	19	10,500.11
	28	10,400.16
	28	10,500.12
	30	10,400.17
3	. . .	1200.10
	. . .	2100.02
	. . .	2100.06
	. . .	2100.07
	. . .	2100.15
	. . .	8015.17
	. . .	8015.50
	. . .	8015.51
	2	2100.06
	2	2600.01
	3	10,400.19
	4	10,400.20
	5	2600.04
4	. . .	1200.11
	. . .	2100.02
	. . .	2100.09
	. . .	2100.15
	. . .	2200.16
5	. . .	1200.12
	. . .	2100.02
	. . .	2100.09
	. . .	2100.10
	. . .	2100.15
6	. . .	1200.13
	. . .	2100.02
	. . .	2100.11
	. . .	2100.12
	. . .	2100.13
	. . .	2100.15
7	. . .	1200.12
	. . .	1200.14
	. . .	2100.02
	. . .	2100.03
	. . .	2100.05
	. . .	2100.10
	. . .	2100.14
	. . .	2200.16
	. . .	2300.12
	. . .	3105.03
	. . .	8015.02
	. . .	8015.05
	. . .	8015.35
	. . .	8015.57

Statements on Standards for Accounting and Review Services—continued

No.	Par.	Sec.
7	. . .	8015.89
	. . .	10,400.01
	. . .	10,400.02
	. . .	10,400.03
	. . .	10,400.04
	. . .	10,400.05
	. . .	10,400.06
	. . .	10,400.07
	. . .	10,400.08
	. . .	10,400.09
	. . .	10,400.10
	. . .	10,400.11
	. . .	10,400.12
	. . .	10,400.13
	. . .	10,400.14
	. . .	10,400.15
	. . .	10,400.16
	. . .	10,400.17
	. . .	10,400.18
	. . .	10,400.19
	. . .	10,400.20
	. . .	10,400.21
	. . .	10,400.22
	. . .	10,400.23
	. . .	10,400.24
	. . .	10,400.25
	. . .	10,500.01
	. . .	10,500.02
	. . .	10,500.03
	. . .	10,500.04
	. . .	10,500.05
	. . .	10,500.06
	. . .	10,500.07
	. . .	10,500.08
	. . .	10,500.09
	. . .	10,500.10
	. . .	10,500.11
	. . .	10,500.12
	. . .	10,500.13
	. . .	10,500.14
	. . .	10,500.15
	. . .	10,500.16
	. . .	10,500.17

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Accounting and Review Services Interpretations

SSARS No.	Interp. No.	Sec.	
1	1	2200.14	
	3	8015.20	
	4	2300.13	(15)
	4	2300.18	(20)
	4	2400.15	
	4	2400.16	
	4	8015.26	
	11	2500.27	
	11	10,400.21	
	11	10,500.15	
	12	8015.44	
	12	10,400.07	
	12	10,400.08	
	12	10,400.09	
	12	10,400.10	
	12	10,500.05	
	12	10,500.06	
	12	10,600.12	
	15	8015.48	

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Statements on Quality Control Standards

No.	Par.	Sec.
1		
	. . .	5610.01
	. . .	9100.07
	. . .	11,100.02
	3	11,100.03
	6	11,100.04
	7h	3125.17

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Quality Control Policies and Procedures for CPA Firms

Sec.	Par.	Sec.
90	.09	3115.02
	.10	3115.02
	.11	3110.02
	.12	3110.02

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SECURITIES AND EXCHANGE COMMISSION

Staff Accounting Bulletins

No.	Topic	Sec.
40	2D	8210.38
63	5O	8200.13
67	. . .	8160.50
	11M	8050.112
83	4D	8200.19
87	5W	8040.80
92	5Y	8010.26
	5Y	8010.27
	5Y	8010.157
	5Y	8040.80
	5Y	8050.85
	5Y	8120.12
	5Y	8160.12
	5Y	8160.13
	5Y	8200.17
	5Y	8210.29
93	5Z	8010.157

Financial Reporting Releases

No.	Sec.
28	8050.123
	8050.124
38	8210.35

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FINANCIAL ACCOUNTING STANDARDS BOARD

FASB Statements

No.	Par.	Sec.	
2	. . .	8080.17	
	. . .	8200.10	
5	. . .	2500.27	
	. . .	5400.180	(XXIX)A3b
	. . .	5400.180	(XXIX)A5
	. . .	7300.01	
	. . .	7300.02	
	. . .	7400.01	
	. . .	8010.12	
	. . .	8010.21	
	. . .	8010.25	
	. . .	8010.66	
	. . .	8010.99	
	. . .	8010.128	
	. . .	8010.141	
	. . .	8010.143	
	. . .	8015.68	
	. . .	8015.75	
	. . .	8015.77	
	. . .	8020.38	
	. . .	8020.54	
	. . .	8030.45	
	. . .	8040.22	
	. . .	8040.51	
	. . .	8040.64	
	. . .	8040.79	
	. . .	8050.102	
	. . .	8050.121	
	. . .	8060.38	
	. . .	8070.35	
	. . .	8100.13	
	. . .	8110.24	
	. . .	8120.11	
	. . .	8120.15	
	. . .	8140.29	
	. . .	8140.45	
	. . .	8180.30	
	. . .	8200.17	
	. . .	8210.28	
	. . .	8210.32	
	. . .	9210.140	(II)M5
	. . .	9230.080	(II)G2
	84	8015.77	
	103	5400.100	(XIII)

FASB Statements—continued

No.	Par.	Sec.	
6	. . .	8030.36	
12	. . .	8010.146	
	. . .	8015.78	
	. . .	8020.42	
	. . .	8040.68	
	. . .	8040.75	
	. . .	8050.106	
	. . .	8140.33	
	11	6500.250	
13	. . .	8210.25	
14	. . .	8050.86	
15	. . .	8010.141	
	. . .	8015.75	
	. . .	8020.38	
	. . .	8040.64	
	. . .	8050.102	
	. . .	8110.20	
	. . .	8140.29	
	. . .	8210.21	
	. . .	8210.32	
	. . .	9240.060	(II)E16c
16	. . .	5400.150	(XXIII)B3
	. . .	5400.155	(XXIV)C3
	11	10,260.150	
22	12	9210.210	(III)N1
	13	9210.210	(III)N1
	14	9210.210	(III)N1
	15	9210.210	(III)N1
23	7	9210.210	(III)N1
	8	9210.210	(III)N1
	9	9210.210	(III)N1
27	6	9210.210	(III)N1
	7	9210.210	(III)N1
	8	9210.210	(III)N1
28	2	9210.210	(III)N1
	3	9210.210	(III)N1
29	10	9210.210	(III)N1
	11	9210.210	(III)N1
	12	9210.210	(III)N1
34	. . .	5600.100	(X)B1m
35	. . .	8060.04	
	. . .	8060.36	
	. . .	8060.40	
47	. . .	2500.27	
	. . .	8010.120	

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48	. . .	8200.06
52	. . .	8020.18
	. . .	8040.38
	. . .	8050.75
	. . .	8080.21
	. . .	8150.26
	. . .	8170.28
57	. . .	8030.43
	. . .	8210.22
	24	7400.01
60	. . .	8040.52
	. . .	8040.75
	. . .	8060.36
	7a	8040.60
	14a	8040.60
	14b	8040.60
	60	8040.24
65	. . .	8020.42
	. . .	8040.68
	. . .	8050.106
	. . .	8140.33
66	. . .	8010.95
	. . .	8050.47
	. . .	8050.83
	. . .	8210.22
67	. . .	8040.43
68	. . .	8200.12
	. . .	8200.13
	. . .	8200.14
	. . .	8200.15
69	. . .	8160.35
	. . .	8160.48
	21	8160.42
78	. . .	8010.102
80	. . .	8020.18
	. . .	8040.38
	. . .	8050.75
	. . .	8080.21
	. . .	8080.31
	. . .	8140.26
	. . .	8160.48
	. . .	8170.28
87	. . .	7200.15
	. . .	8010.20
88	. . .	7200.15
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	6	8020.52	
	6	8050.119	
	6	8140.43	
93	. . .	8180.43	
95	. . .	6500.062	
	. . .	8010.120	
	. . .	10,850.01	
	. . .	10,900.01	
	. . .	10,900.02	
	. . .	10,900.03	
	. . .	10,900.04	
	. . .	10,900.05	
	3	2500.21	
97	. . .	8040.75	
98	12	9210.210	(III)N1
102	. . .	10,850.01	
	. . .	10,900.01	
	. . .	10,900.02	
	. . .	10,900.03	
	. . .	10,900.04	
	. . .	10,900.05	
104	. . .	8080.32	
	. . .	8160.49	
105	. . .	5400.075	(VIII)A5c
	. . .	8010.120	
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	. . .	8040.37	
	. . .	8040.54	
	. . .	8050.74	
	. . .	8080.20	
	. . .	8110.21	
	. . .	8150.25	
	. . .	8170.27	
106	. . .	8010.19	
	. . .	8010.20	
	. . .	8010.129	
	. . .	8010.131	
	. . .	8015.69	
	. . .	8130.38	
	. . .	8130.39	
	186	8010.20	
	187	8010.20	
	188	8010.20	
	189	8010.20	

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	191	8010.20	
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107	. . .	8010.23	
	. . .	8020.17	
	. . .	8040.37	
	. . .	8040.42	
	. . .	8050.74	
	. . .	8060.39	
	. . .	8060.40	
	. . .	8080.20	
	. . .	8120.14	
	. . .	8150.25	
	. . .	8170.27	
	. . .	8190.23	
	10	8060.39	
	11	8060.39	
	12	8060.39	
	13	8060.39	
	14	8060.39	
109	. . .	5400.130	(XIX)A7
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	. . .	8010.134	
	. . .	8010.136	
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	. . .	8015.72	
	. . .	8050.22	
	. . .	8080.16	
	. . .	8110.22	
	. . .	8120.19	
110	. . .	8060.36	
	. . .	8060.39	
112	. . .	8010.19	
	. . .	8010.126	
	. . .	8015.67	
113	. . .	8040.52	
	. . .	8040.53	
	. . .	8040.55	
	. . .	8040.56	
	8	8040.60	
	9	8040.60	
	10	8040.60	
	11	8040.60	
	12	8040.60	
	13	8040.60	
	21	8040.60	
114	. . .	8010.140	

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	. . .	8010.157
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	. . .	8015.76
	. . .	8015.77
	. . .	8015.85
	. . .	8020.36
	. . .	8020.37
	. . .	8040.62
	. . .	8040.63
	. . .	8040.64
	. . .	8040.65
	. . .	8040.67
	. . .	8050.100
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115	. . .	8010.146
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	. . .	8015.78
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	. . .	8040.68
	. . .	8040.69
	. . .	8040.70
	. . .	8040.73
	. . .	8040.74
	. . .	8050.46
	. . .	8050.74
	. . .	8050.100
	. . .	8050.106
	. . .	8050.107
	. . .	8050.108
	. . .	8050.111
	. . .	8050.112
	. . .	8050.114
	. . .	8050.122
	. . .	8050.125
	. . .	8050.126
	. . .	8080.20
	. . .	8140.27
	. . .	8140.33
	. . .	8140.34
	. . .	8140.35
	. . .	8140.38
	. . .	8140.39
	. . .	8210.30
	8	8010.148
	8	8015.80
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	8	8040.71
	8	8050.109
	8	8140.36
116	. . .	8010.151
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	. . .	8030.51
	. . .	8180.44
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117	. . .	8010.157
	. . .	8015.85
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	. . .	8040.37
	. . .	8040.56
	. . .	8050.74
	. . .	8080.20
	. . .	8150.25
	. . .	8170.27
40	. . .	8010.157
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7	11	8070.58	
	12	8070.58	
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8	. . .	8190.38	
10	. . .	8070.47	
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17	. . .	8070.47	
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19	. . .	8070.51	
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